# EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND ICELAND

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On July 10, 2008

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

July 8, 2008
JCX-58-08

**CONTENTS**

## INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and Iceland as supplemented by a protocol. The provisions of the protocol, by its terms, form an integral part of the proposed treaty. Unless otherwise specified, the proposed treaty and the protocol are hereinafter referred to collectively as the "proposed treaty." The proposed treaty was signed on October 23, 2007. The Senate Committee on Foreign Relations (the "Committee") has scheduled a public hearing on the proposed treaty for July 10, 2008.[2]

Part I of the pamphlet provides a summary of the proposed treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of Icelandic tax laws. Part IV provides a discussion of investment and trade flows between the United States and Iceland. Part V contains an article-by-article explanation of the proposed treaty. Part VI contains a discussion of issues relating to the proposed treaty.

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Iceland* (JCX-58-08), July 8, 2008. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at www.jct.gov.

[2] For a copy of the proposed treaty, *see* Senate Treaty Doc. 110-17.

## I. SUMMARY

The principal purposes of the proposed treaty are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries. As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains certain exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16). The proposed treaty also provides that pensions and other similar remuneration paid to a resident of one country may be taxed only by that country, and only at such time and to the extent that a pension distribution is made (Article 17).

The proposed treaty provides that dividends and certain gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends may be limited by the proposed treaty. The proposed treaty provides that, subject to certain rules and exceptions, interest and most types of royalties derived by a resident of either country from sources within the other country may be taxed only by the residence country (Articles 11 and 12). Notwithstanding this general rule, the source country may impose tax on certain royalties in an amount not to exceed five percent of such royalties.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 22).

The proposed treaty contains the standard provision (the "saving clause") included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits to which the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty (Article 19) generally provides that students, business trainees, and researchers visiting the other treaty country are exempt from host country taxation on certain types of payments received.

The proposed treaty provides authority for the two countries to resolve disputes (Article 24) and exchange information (Article 25) in order to carry out the provisions of the proposed treaty.

The proposed treaty also contains a detailed limitation-on-benefits provision that reflects the anti-treaty-shopping provisions included in the United States Model Income Tax Convention of November 15, 2006 ("U.S. Model treaty") and more recent U.S. income tax treaties. The new rules are intended to prevent the inappropriate use of the treaty by third-country residents (Article 21).

The provisions of the proposed treaty will have effect generally on or after the first day of January following the date that the proposed treaty enters into force. The proposed treaty allows taxpayers to temporarily continue to claim benefits under the present treaty for up to an additional year if they would have been entitled to greater benefits under the present treaty. In addition, a teacher entitled to benefits under the present treaty at the time the proposed treaty enters into force will continue to be entitled to the benefits available under the present treaty for as long as such individual would have been entitled to the previously existing benefits.

The proposed treaty replaces the existing treaty (signed in 1975). The rules of the proposed treaty generally are similar to rules of recent U.S. income tax treaties, the U.S Model treaty,[3] and the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development ("OECD Model treaty"). However, the proposed treaty contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed treaty in Part V of this pamphlet.

[3] For a comparison of the U.S. Model treaty with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

## II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

### A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, special limitations apply to credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil related income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

## B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the "IRS") and the treaty partner's tax authorities can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty-shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

## III. OVERVIEW OF TAXATION IN ICELAND[4]

### A. National Income Taxes

**Overview**

Iceland imposes income tax on income at the national level. Taxable income is computed on an annual basis and is taxed either by assessment or by a final withholding tax. For individuals, the rates of tax and deductions allowed depend on the type of income earned. Since 1999, Iceland has had a classical corporate taxation system, and companies generally may deduct dividends received from resident and nonresident companies. Individual shareholders receive a reduced tax rate on dividends. Under recently enacted legislation, if certain requirements are satisfied, no tax is imposed on capital gain from an individual's or a corporation's sale of stock in a company.

**Individuals**

Individuals resident in Iceland are taxed on their worldwide income.[5] Sources of taxable income include income from three categories: (1) wages, salaries, benefits, pensions, social security payments, grants, royalties, and payments to copyright holders, (2) business and independent economic activity income, and (3) investment income (e.g., dividends, interest, and capital gains).[6] Operating losses may be deducted only from income in the second category. For individuals engaged in a business, the three categories of income are aggregated and taxed at normal rates. For individuals not engaged in business, the income in the first and second categories is aggregated and taxed at a rate of 22.75 percent, while the income in the third category is taxed at a flat 10-percent rate. Tax on employment income, including pensions and benefits-in-kind, is withheld by the employer on a monthly basis.[7] Expenses related to acquiring investment income are not deductible.[8] In general, taxes withheld on investment income are creditable. Royalty payments are not considered investment income, and related expenses are deductible. The taxation of capital gains depends on the type of property sold; gains from the

---

[4] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part G. Valdimarsson, International Bureau of Fiscal Documentation European Taxation, Iceland ("IBFD Iceland, Country Survey"), available at http://checkpoint.riag.com. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition. The quoted tax rates and threshold amounts apply in 2008. U.S. dollar equivalents were calculated using the currency rate for January 1, 2008, according to OANDA's FX Converter, *available at* http://www.oanda.com.

[5] IBFD Iceland, Country Survey B.1.2.1.

[6] IBFD Iceland, Country Survey B.1.2.1.

[7] IBFD Iceland, Country Survey B.1.9.2.

[8] IBFD Iceland, Country Survey B.1.5.

sale of privately owned moveable property are not taxed, unlike gains from the sale of privately owned shares, gains from the sale of certain private residences, gains from the sale of nonbusiness immoveable property, and gains from the sale of property derived in the course of a business. From the beginning of 2008, capital gains on the income from sales of shares generally have been abolished.[9]

In 2008 and later years, the national income tax rate on aggregate income is 22.75 percent.[10] There is also a municipal tax of 12.97 percent collected by withholding. In total, the withholding taxes in Iceland are 35.72 percent.[11]

Tax relief is provided in the form of several deductions and allowances. For example, an individual's four-percent pension insurance premium is deductible from employment income. Child benefits are granted for every child subject to income thresholds.[12] A personal exemption of ISK 408,409 ($6,546) is deducted from the calculated tax. An unused tax credit is transferable between spouses.[13] There is also a fisherman's exemption of ISK 874 ($14) per day.[14]

**Corporations**

Corporations resident in Iceland are subject to a corporate tax on their worldwide income.[15] A legal entity is a resident of Iceland if it is registered in Iceland, if its articles of incorporation provide that its home is in Iceland, or if its effective place of management is Iceland.[16] Resident entities subject to the corporate tax include registered corporate entities where participators are not personally liable for the entities' debts; commercial banks and lending institutions; mutual insurance associations and cooperative societies; general, limited, and limited liability partnerships registered as taxable entities; registered public and private companies; marketing and production organizations; and other entities that carry on a business.

---

[9] Worldwide Tax Daily, 2008 WTD 107-3.

[10] IBFD Iceland, Country Survey B.1.9.1.

[11] Internal Revenue Directorate, http://rsk.is/international/en and Nordisk eTax, http://www.nordisketax.net/main.asp?url=/hem.asp&c=isl&l=eng&s=1&w=3&m=02.

[12] Principal Tax Rates 2008, Icelandic Ministry of Finance, http://eng.fjarmalaraduneyti.is/customs-and-taxes/principaltaxrates/nr/10062.

[13] Principal Tax Rates 2008, Icelandic Ministry of Finance, http://eng.fjarmalaraduneyti.is/customs-and-taxes/principaltaxrates/nr/10062.

[14] *Id*.

[15] IBFD Iceland, Country Survey A.1.3.1.

[16] IBFD Iceland, Country Survey A.1.2.1.

The standard corporate tax rate is 18 percent. This rate also generally applies to limited liability companies. A 26-percent rate applies to partnerships registered as taxable entities.[17] Under legislation recently passed by the Icelandic Parliament, the partnership tax rate is reduced to 23.5 percent, and the limited liability company rate is reduced to 15 percent.[18] Capital gains derived by resident entities are generally aggregated with all other income for taxation at the corporate rate. Capital losses are generally not deductible but may offset gains from the sale in the same year of similar assets. Under the recent legislation, a corporation generally is exempt from tax on capital gain from the sale of shares in resident and nonresident companies if, in the case of a nonresident company, the company is subject to taxation similar to the taxation of Icelandic companies and at a rate at least as high as the rate generally applicable in OECD member countries or European Economic Area member states.[19] Net operating loss carrybacks are not permitted, but losses may be carried forward 10 years.[20]

The taxation of dividends depends on the type of recipient. Dividends paid by a resident company to a resident corporate shareholder are subject to a 10-percent withholding tax and may be deducted by the recipient. Dividends paid to a resident individual shareholder are taxed at a reduced rate.[21] Resident companies generally may deduct dividends received from both resident and nonresident companies.

---

[17] IBFD Iceland, Country Survey A.1.6.1.

[18] Deloitte, International Tax, Iceland Tax Alert, June 2, 2008, http://www.deloitte.com/dtt/cda/doc/content/dtt_tax_alert_iceland_060208.pdf.

[19] *Id.*

[20] IBFD Iceland, Country Survey A.1.5.1. and 2.

[21] IBFD Iceland, Country Survey A.1.1 and A.1.6.2.

## B. International Aspects of Taxation in Iceland

**Individuals**

Individuals resident in Iceland are taxed on their worldwide income.[22] An individual is considered a resident of Iceland if he stays in Iceland for six months or longer.[23] Nonresident individuals are taxed only on their Icelandic-source income and capital gains.[24] A 15-percent assessment is imposed on Icelandic-source salaries, wages, grants, director and committee member income, independent personal service income, and art performance income.[25] Iceland requires a withholding tax on dividends paid by resident companies to nonresident individuals at a rate of 10 percent.[26] Icelandic-source interest derived by nonresidents is tax exempt. Royalty income arising from Icelandic sources is subject to a 35.72-percent final withholding tax. Icelandic-source business income derived by nonresidents is taxed the same as if derived by a resident. A 10-percent tax is assessed on nonresident individuals on gains from the sale or lease of property located in Iceland.

**Corporations**

Companies resident in Iceland are generally taxed on their worldwide income. A foreign company is subject to the Icelandic corporate tax on income derived through the carrying on of, participation in, or entitlement to a share of profits of a business through a permanent establishment in Iceland.

Nonresidents are taxed on capital gains realized on property located Iceland and intangibles pertaining to an Icelandic permanent establishment. Under recently-enacted legislation, nonresident companies are exempt from taxes on capital gains from the sale of Icelandic company shares. Icelandic-source interest paid to nonresidents is not subject to withholding tax. Royalty payments made to nonresident companies are subject to tax on their net amount. Because the royalties are subject to withholding tax at the general corporate rate, any tax withheld is credited against the final tax liability.

The Icelandic Parliament approved an amendment to the Income Tax Act on May 30, 2008 to reduce withholding taxes on dividends paid to nonresident companies.[27] The new withholding tax rate, 10 percent, is the same as the rate applicable to dividends paid to resident

---

[22] IBFD Iceland, Country Survey B.1.2.1.

[23] IBFD Iceland, Country Survey B.1.1.

[24] IBFD Iceland, Country Survey B.6.3.1.

[25] IBFD Iceland, Country Survey B.6.3.1.

[26] IBFD Iceland, Country Survey B.6.3.1.

[27] Worldwide Tax Daily, 2008 WTD 107-3.

companies.[28] Under the legislation, tax on dividends paid to companies within the European Economic Area is abolished.[29]

**Relief from double taxation**

In the absence of a treaty, relief from double taxation of foreign source income generally is provided in the form of a tax credit.

[28] Deloitte, International Tax, Iceland Tax Alert, June 2, 2008, http://www.deloitte.com/dtt/cda/doc/content/dtt_tax_alert_iceland_060208.pdf.

[29] *Id.*

## C. Other Taxes

**Inheritance, gift, and wealth taxes**

Iceland imposes a five-percent inheritance tax where the decedent was an Icelandic resident at the time of death. Each beneficiary is permitted an ISK 1 million ($16,026) exemption. Inheritances received by spouses and cohabitants are fully exempt. Iceland has no gift tax; however, gifts are included in taxable income. Certain gifts may be exempt from tax if they are of value considered normal under the circumstances. Iceland does not impose a wealth tax.[30]

**Social security**

Social security contributions are paid by employers and self-employed individuals in Iceland. In addition, all employees must pay a deductible four percent pension insurance premium into a public pension fund.

A flat tax rate of ISK 7,103 ($114) per year is levied for the Construction Fund for the Elderly, a central government fund that finances the construction and operation of nursing homes and senior care centers. Individuals under the age of 16 and over the age of 69 are exempt from this tax, as are those with incomes below ISK 1,080,067 ($17,313) in 2008.[31]

**Other indirect taxes**

Iceland imposes a value added tax (VAT) on the consumption of goods and services. The standard VAT rate is 24.5 percent, but the rate is reduced for certain products and services,[32] and some products and services are exempt from VAT. Stamp duties are levied on a number of documents.

---

[30] IBFD Iceland, Country Survey B.5.

[31] Principal Tax Rates 2008, Icelandic Ministry of Finance, http://eng.fjarmalaraduneyti.is/customs-and-taxes/principaltaxrates/nr/10062.

[32] IBFD Iceland, Country Survey A.8.6.

## IV. THE UNITED STATES AND ICELAND: CROSS-BORDER INVESTMENT AND TRADE

### A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed treaty it may be beneficial to examine the cross-border trade and investment between the United States and Iceland. Whether measured by trade in goods or services or by direct and non-direct cross-border investment, the United States and Iceland engage in modest cross-border activity at present. The income from cross-border trade and investment generally is subject to income tax in either the United States or Iceland and in many cases the income is subject both to gross basis withholding taxes in the source country and net basis income tax in the residence country.

## B. Overview of International Transactions Between the United States and Iceland

**Cross-border trade**

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and Iceland is not publicly available, one can document the value of trade between the United States and Iceland. In 2007, the United States exported $630 million of goods to Iceland and imported $206 million in goods from Iceland. This made Iceland the United States' 84th largest merchandise export destination and the 112th largest source of imported merchandise.[33]

**Cross-border investment**

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

Commensurate with the size of Iceland's economy in comparison to other European countries, the value of cross-border investment, between the United States and Iceland is significantly smaller than that of cross border investment between the United States and other European countries. The Bureau of Economic Analysis estimates that the value of direct investments in Iceland held by U.S. averaged approximately $4 million annually on a historic cost basis for the period 2002 through 2005. The Bureau of Economic Analysis estimated Icelandic persons held direct investments in the United States valued at $2.2 billion in 2003 and that such direct investments had grown in value to $7.4 billion in 2005.[34]

---

[33] Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2007," June 10, 2008.

[34] Jeffrey H. Lowe, "U.S. Direct Investment Abroad: Detail for Historical-Cost Position and Related Capital and Income Flows, 2004-2006," *Survey of Current Business*, vol. 87, September 2007, and Jeffrey H. Lowe, "Foreign Direct Investment in the United States: Detail for Historical-Cost Position and Related Capital and Income Flows, 2004-2006," *Survey of Current Business*, vol. 87, September 2007. Data for 2006 suppressed to avoid disclosure of individual companies. Data related to direct

U.S. direct investments in Iceland produced approximately $4 million in income to U.S. persons in 2006. Icelandic direct investments in the United States produced approximately $263 million in income to Icelandic persons in 2006.[35]

The data presented above do not report the amount of U.S. or Icelandic portfolio investments, holdings of stocks and bonds (including holdings of U.S. government securities). The Bureau of Economic Analysis generally only reports portfolio holdings by country for the several largest portfolio investment countries.

---

investment holdings by Icelandic persons in 2002 also were suppressed to avoid disclosure of individual companies..

[35] *Ibid.* The Bureau of Economic Analysis reports income net of withholding taxes prior to 2006. Between 2002 and 2005 income to U.S. persons from direct investments in Iceland ranged from $1 million to $2 million annually net of withholding taxes. To protect the confidentiality of individual companies, the Bureau of Economic Analysis did not disclose comparable data for income paid to owners of Icelandic direct investments located in the United States.

### C. Analyzing the Economic Effects of Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and Icelandic income tax liabilities.

Generally, the treaty-based reduced withholding rates in the present treaty are maintained in the proposed treaty. The reduced withholding rates encourage more cross-border investment and income flows between the treaty parties, compared to investments in nontreaty countries. Over the longer term, the withholding tax rates of the present and proposed treaties, coupled with other proposed changes in the present treaty, are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of the proposed treaty would account for both tax and non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

## V. EXPLANATION OF PROPOSED TREATY AND PROTOCOL

### Article 1. General Scope

#### In general

The general scope article describes the persons who may claim the benefits of the proposed treaty. It also includes a "saving clause" provision similar to provisions found in most U.S. income tax treaties, and a special rule for fiscally transparent entities similar to that found in the U.S. Model treaty.

Paragraph 1 provides that the proposed treaty generally applies only to residents of the United States and to residents of Iceland. The determination of whether a person is a resident of the United States or Iceland is made under Article 4 of the proposed treaty (Resident). Certain provisions are applicable to persons who may not be residents of either treaty country. For example, paragraph 1 of Article 23 (Non-Discrimination) applies to nationals of the treaty countries. Under Article 25 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third countries.

Paragraph 2 states the generally accepted relationship both between the treaty and domestic law, and between the treaty and other agreements to which the United States and Iceland are parties. It provides that the treaty does not restrict any benefit accorded by internal law or by any other agreement between the United States and Iceland. This means that the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Iceland beyond that determined under internal law.

Under the principles of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the proposed treaty if the Code would produce a more favorable result. The Technical Explanation states, however, that a taxpayer may not choose among the provisions of the Code and the proposed treaty in an inconsistent manner in order to minimize tax. The Technical Explanation includes an example illustrating this rule. In the example, a resident of Iceland has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income (or loss) under the Code but that do not meet the permanent establishment threshold tests of the proposed treaty. One is profitable and the other incurs a loss. Under the proposed treaty, the profits of the permanent establishment are taxable in the United States, and the income and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the income of the two profitable ventures. The Technical Explanation states that the taxpayer may not invoke the proposed treaty to exclude the income of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the income of the permanent establishment. However, if the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the proposed treaty with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Notwithstanding the foregoing, paragraph 2 provides that: (1) the provisions of Article 24 (Mutual Agreement Procedure) apply to any dispute concerning whether a measure is within the scope of the proposed treaty, and that the procedures under the proposed treaty shall apply to that dispute; and (2) with respect to any taxation measure within the scope of the proposed treaty, the non-discrimination obligations of the proposed treaty apply exclusively (except for such national treatment or most-favored nation obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade). For purposes of paragraph 2, a "measure" is a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

Saving clause

Like all U.S. income tax treaties and the U.S. Model treaty, the proposed treaty includes a "saving clause" in paragraph 4. Under this clause, with specific exceptions described below, the proposed treaty does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, subject to the exceptions described below, the United States may continue to tax its citizens who are residents of Iceland as if the treaty were not in force.

Paragraph 4 also provides that the United States may tax, in accordance with the laws of the United States, a former citizen or former long-term resident of the United States for a period of ten years following the loss of citizenship or long-term resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax (for a period of ten years) on certain former U.S. citizens and former long-term residents who relinquish their citizenship or cease to be a long-term resident prior to June 17, 2008. Under U.S. domestic law, an individual is considered a "long-term resident" of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident.

For any individual who relinquishes U.S. citizenship or ceases to be a lawful permanent resident of the United States ("expatriates") on or after June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008,[36] replaces section 877 with a new set of special rules. In general, to the extent those rules impose U.S. tax on an individual after the individual expatriates, they require or deem the individual to waive any rights to claim a reduction in U.S. tax under a U.S. tax treaty and any other rights under a U.S. tax treaty that would preclude the assessment or collection of tax imposed by the new rules.

Paragraph 5 contains exceptions to the saving clause. Exceptions to the saving clause are provided for the following benefits conferred by the proposed treaty: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); benefits relating to social security payments and pensions (Article 17, paragraphs 2 and 4); relief from double taxation through the provision of a foreign tax credit (Article 22); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 23); and benefits under the mutual agreement procedures of the treaty (Article 24).

[36] Pub. L. No. 110-245, sec. 301 (June 17, 2008).

In addition, the saving clause does not apply to certain benefits conferred by the United States or Iceland upon individuals who are neither citizens of, nor have been admitted for permanent residence in, the United States or Iceland, respectively. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Iceland who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a "green card"). The benefits that are covered under this set of exceptions are exemptions from host country taxation for certain income for government service (Article 18), certain income received by students, trainees, and researchers (Article 19), and certain income received by members of diplomatic missions and consular posts (Article 26).

Fiscally transparent entities

Paragraph 6 sets forth a special rule for partnerships, trusts, and estates ("fiscally transparent entities"). Under this rule, income derived though an entity that is a partnership, trust, or estate under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident, either in the hands of the entity or in the hands of its partners or beneficiaries. For example, if a corporation resident in Iceland distributes a dividend to an entity that is treated as fiscally transparent for U.S. tax purposes, the dividend will be considered derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the dividend income for U.S. tax purposes.

The Technical Explanation states that the result in the above example would be the same if the entity were viewed differently under the laws of Iceland (i.e., as not fiscally transparent). The Technical Explanation also states that this result follows regardless of whether the entity is organized in the United States, Iceland, or a third country. As an example, the Technical Explanation states that income from sources in Iceland received by an entity organized under the laws of Iceland, which is treated for U.S. tax purposes as a corporation and is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of Iceland, the entity is treated as fiscally transparent. Finally, the Technical Explanation states that these results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for Icelandic tax purposes.

Paragraph 6 is not an exception to the saving clause in paragraph 4. Accordingly, paragraph 6 does not prevent a treaty country from taxing an entity that is treated as a resident of that treaty country under its tax laws. For example, if a U.S. corporation has Icelandic shareholders, the United States will tax the corporation on its worldwide income on a net basis, without regard to whether Iceland views the corporation as fiscally transparent. Similarly, if an entity organized in Iceland and owned by U.S. residents is treated as a corporation under the tax laws of Iceland, Iceland may tax the entity on its worldwide income on a net basis, even if the United States views the entity as fiscally transparent.

**Article 2. Taxes Covered**

The proposed treaty applies to all taxes on income irrespective of the manner in which they are levied, including taxes on gains from the alienation of property and on the total amounts of wages or salaries paid by enterprises, but excluding social security taxes and taxes on capital appreciation. In the case of Iceland, the proposed treaty applies to the income taxes to the state and the municipalities. In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code and to Federal excise taxes imposed with respect to private foundations.

The proposed treaty also applies to any taxes that are identical or substantially similar to the taxes described in the preceding paragraph and that are imposed after the signing of the proposed treaty in addition to or in place of existing taxes. This provision generally is found in U.S. income tax treaties. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal taxation or other laws that significantly affect a country's obligation under the proposed treaty.

**Article 3. General Definitions**

This article provides definitions of a number of terms for purposes of the proposed treaty. Certain of the standard definitions found in most U.S. income tax treaties are included in the article.

The article sets forth the geographical scope of the proposed treaty with respect to Iceland and the United States. In the case of Iceland, it encompasses the territory of Iceland, including its territorial sea, and any area beyond the territorial sea within which Iceland, in accordance with international law, exercises jurisdiction or sovereign rights with respect to the sea bed, its subsoil and its superadjacent waters, and their natural resources. In the case of the United States, it encompasses the United States of America, including the States and the District of Columbia, and the territorial sea thereof. It also includes the sea bed and the subsoil of the submarine areas adjacent to the territorial sea, over which the United States exercises sovereign rights in accordance with international law. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory.

The term "person" includes an individual, a trust, a partnership, a company, and any other body of persons.

The term "company" means a body corporate or an entity treated as a body corporate for tax purposes in the country where it is organized.

The term "enterprise" applies to the carrying on of any business. The term "business" is not defined, but the proposed treaty provides that the term includes the performance of professional services and other activities of an independent character. According to the Technical Explanation, this is intended to clarify that income from the performance of professional services or other activities of an independent character is dealt with under Article 7 (Business Profits) and not Article 20 (Other Income).

The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country. The Technical Explanation clarifies that an enterprise of a treaty country need not be carried on in that country.

The terms “a Contracting State” and “the other Contracting State” mean Iceland or the United States, as the context requires.

The term “international traffic” means any transport by a ship or aircraft except when such transport is solely between places within a treaty country. This definition is applicable principally in the context of Article 8 (Shipping and Air Transport).

The article designates the “competent authorities” for Iceland and the United States. In the case of Iceland, the competent authority is the Minister of Finance or his authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. According to the Technical Explanation, the Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Deputy Commissioner (International) LMSB.

The term “national,” as it relates to the United States and to Iceland, means (1) an individual who is a citizen or national of that State, and (2) any legal person, partnership, or association deriving its status, as such, from the laws of a contracting state. This term is relevant for purposes of Articles 18 (Government Service) and 23 (Non-Discrimination).

The term “pension scheme” means any plan, scheme, fund, trust or other arrangement established in a treaty country that: (1) is generally exempt from income taxation in that country; and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.

The protocol to the proposed treaty provides that, in the case of Iceland, any pension fund or pension plan qualified under the Pension Act or any identical or substantially similar schemes created under any law enacted after October 23, 2007, the date of signature of the proposed treaty, are considered to meet the requirements of a “pension scheme.” In the case of the United States, the protocol provides that the following plans are considered to meet these requirements: qualified plans under section 401(a) of the Code, individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts, individual retirement annuities, section 408(p) accounts, and Roth IRAs under section 408A), section 457(g) governmental plans, section 403(a) qualified annuity plans, section 403(b) plans, and any identical or substantially similar schemes created under any law enacted after October 23, 2007. In addition, the Technical Explanation clarifies that the Thrift Savings Fund provided in section 7701(j), section 401(k) plans, and certain other plans and group trusts qualify as pension schemes to the extent that they are section 401(a) plans.

Terms that are not defined in the proposed treaty are covered in paragraph 2. Paragraph 2 provides that in the application of the proposed treaty, any term not defined in the proposed treaty will have the meaning that it has under the law of the county whose tax is being applied, unless the context requires otherwise or the competent authorities have agreed on a different meaning pursuant to Article 24 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a treaty country, the definition in the tax law prevails.

## Article 4. Resident

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that term is defined in the proposed treaty. Issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries.

### Internal taxation rules

#### United States

Under U.S. law, an individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (that is, a "green card" holder) also is treated as a U.S. resident. U.S. residents are taxed on their worldwide income. Under U.S. law, a company is taxed on its worldwide income if it is a "domestic corporation." A domestic corporation is one that is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

#### Iceland

An individual is considered a resident of Iceland if he stays in Iceland for six months or longer. Under Icelandic law, resident individuals are subject to tax on their worldwide income, while nonresident individuals generally are subject to tax only on income arising in Iceland.

A legal entity is a resident of Iceland if it is registered in Iceland, if its articles of incorporation provide that its home is in Iceland, or if its effective place of management is Iceland. Companies that are resident in Iceland are subject to tax on their worldwide income. A foreign company is subject to the Icelandic corporate tax on income derived through the carrying on of, participation in, or entitlement to a share of profits of a business through a permanent establishment in Iceland.

### Proposed treaty rules

Article 4 of the proposed treaty provides rules to determine whether a person is a resident of the United States or Iceland under the proposed treaty. The rules generally are consistent with the rules of the U.S. Model treaty.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that treaty country, is liable to tax therein by reason of the person's domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The term does not include any person who is liable to tax in that treaty country only on income from sources in that country or on profits attributable to a permanent establishment in that country. Accordingly, although not explicitly stated in the proposed treaty, an enterprise of Iceland with a permanent establishment in the United States does not become a resident of the United States as a result of its U.S. permanent establishment. Such an enterprise generally is liable to tax by the United States only on income attributable to its U.S. permanent establishment, not on its worldwide income.

The proposed treaty makes explicit the generally understood practice of including in the definition of "resident of a Contracting State" the two treaty countries and any political subdivisions or local authorities of those countries.

The proposed treaty provides a special rule to treat as residents of a treaty country certain legal entities that generally are exempt from tax in that country. The provision applies to a pension scheme, which is any plan, scheme, fund, trust or other arrangement established in a treaty country that (1) is generally exempt from income taxation in that country, and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. The provision also applies to a plan, scheme, fund, trust, company, or other arrangement established in a treaty country that is operated exclusively to administer or provide employee benefits and that, by reason of its nature as such, is generally exempt from income taxation in that country. In addition, the provision applies to an organization that is a resident of a treaty country under its laws and is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes.

The proposed treaty provides a series of tie-breaker rules to determine residence in the case of an individual who, under the basic residence definition, would be considered to be a resident of both countries. These tie-breaker rules are to be applied in the order in which they are described below. Under these rules, an individual is deemed to be a resident of the country in which he or she has a permanent home available. If the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (that is, the individual's "center of vital interests"). If it cannot be determined in which country the individual has his or her center of vital interests, or if the individual does not have a permanent home available in either country, the individual is deemed to be a resident of the country in which he or she has a habitual abode. If the individual has a habitual abode in both countries or in neither country, the individual is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or of neither country, the competent authorities of the countries will endeavor to settle the question of residence by mutual agreement.

The proposed treaty also provides a tie-breaker rule for persons other than individuals (e.g., companies, trusts, or estates). If, under the general residence rules described above, a person other than an individual is a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by mutual agreement. If the competent authorities are unable to reach mutual agreement, then that person will not be entitled to claim any benefits provided by the proposed treaty, except those provided by Article 23 (Non-Discrimination) and by Article 24 (Mutual Agreement Procedure).

Fiscally Transparent Entities

The residence treatment of items of income, profit, or gain derived through fiscally transparent entities is addressed in paragraph 6 of Article 1 (General Scope) of the proposed treaty.

**Article 5. Permanent Establishment**

The proposed treaty contains a definition of the term “permanent establishment” that generally follows the language of other recent U.S. income tax treaties, the U.S. Model treaty, and the OECD Model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those items of income will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a building site or a construction or assembly project if it lasts for more than 12 months, and includes an installation used for the exploration for natural resources if the activity continues in the treaty country for more than 12 months. The Technical Explanation states that the 12-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the 12-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began.

The proposed treaty provides that the following activities of a preparatory or auxiliary character are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty further provides that a combination of these activities will not give rise to a permanent establishment, if the combination results in an overall activity that is of a preparatory or auxiliary character. These rules are consistent with the OECD and U.S. Model treaties.

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country in the name of the enterprise of the other country and has, and habitually exercises in such first country, the authority to conclude contracts in the name of such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply where the activities are limited to the activities described in the preceding paragraph that would not give rise to a permanent establishment if carried on by the enterprise through a fixed place of business. The Technical Explanation states that the language "in the name of the enterprise," which also appears in the OECD Model treaty, is intended to have the same meaning as the language "binding on the enterprise" found in the U.S. Model treaty. Both phrases are intended to encompass persons who have sufficient authority to bind the enterprise's participation in the business activity in the treaty country.

No permanent establishment is deemed to arise under the proposed treaty if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination, and that the relevant factors in making this determination include: (1) the extent to which the agent operates on the basis of instructions from the principal; (2) the extent to which the agent bears business risk; and (3) whether the agent has an exclusive or nearly exclusive relationship with the principal.

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not cause either company to be a permanent establishment of the other. The Technical Explanation clarifies that, consistent with the U.S. Model treaty, such control is not taken into account in determining whether either company has a permanent establishment in the other treaty country.

**Article 6. Income from Immovable Property (Real Property)**

This article covers income from immovable property (real property). The rules governing gains from the sale of immovable property (real property) are included in Article 13 (Capital Gains). Under the proposed treaty, income derived by a resident of one country from immovable property (real property) situated in the other country may be taxed in that other country. This rule and, in general, the other rules of this article are consistent with the rules in the U.S. and OECD Model treaties.

The term "immovable property (real property)" generally has the meaning that it has under the law of the country in which the property in question is situated. According to the Technical Explanation, in the case of the United States, the term "real property" has the meaning given to it by Treas. Reg. section 1.897-1(b). The proposed treaty provides, however, that regardless of internal law definitions, immovable property (real property) also includes property accessory to immovable property (real property), including livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of immovable property (real property); and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Ships, boats, and aircraft are not regarded as immovable property (real property).

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of immovable property (real property). The rules permitting source-country taxation of income from immovable property (real property) also apply to the income from immovable property (real property) of an enterprise. However, the rules do not apply if the beneficial owner of the income, resident in one treaty country, has a permanent establishment in the other treaty country through which the beneficial owner carries on a business and the income from the immovable property (real property) is effectively connected with that permanent establishment. In such case, the provisions of Article 7 (Business Profits) apply.

The proposed treaty does not grant an exclusive taxing right to the country where the property is located; such country is merely given the primary right to tax. The proposed treaty also does not impose any limitation in terms of the rate or form of tax such country may impose. Thus, the proposed treaty does not include paragraph 5 of Article 6 of the U.S. Model treaty, regarding the allowance of an election to be taxed on a net basis on income from real property. Net basis taxation, however, is available under the tax laws of both the United States and Iceland. Thus, taxpayers generally should be able to obtain the same treatment in the country where the real property is situated regardless of whether the income is treated as business profits attributable to a permanent establishment or income from real property.

## Article 7. Business Profits

### Internal taxation rules

#### United States

U.S. law distinguishes between the U.S. business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) that is effectively connected with the conduct of a trade or business within the United States. The performance of personal services within the United States may constitute a trade or business within the United States.

The treatment of income as effectively connected with a U.S. trade or business depends upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States if the asset generating the income is used in (or held for use in) the conduct of the trade or business or if the activities of the trade or business are a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (under what is referred to as a "force of attraction" rule).

The income of a nonresident alien individual from the performance of personal services within the United States is excluded from U.S.-source income, and therefore is not taxed by the

United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed $3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Foreign source income generally is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. In those circumstances, only three types of foreign source income are considered to be effectively connected income: rents and royalties for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign source income that is effectively connected with a U.S. business of an insurance company.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (section 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within ten years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (section 864(c)(7)).

Iceland

Nonresident individuals are taxed only on their Icelandic-source income and capital gains. Icelandic-source business income derived by nonresidents is taxed the same as if derived by a resident. A foreign company is subject to the Icelandic corporate tax on income derived through the carrying on of, participation in, or entitlement to a share of profits of a business through a permanent establishment in Iceland.

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of a treaty country are taxable in the other treaty country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This rule is one of the basic treaty limitations on a country's right to tax income of a resident of the other country. The rule is similar to the rules found in the U.S. and OECD Model treaties.

Although the proposed treaty does not provide a definition of the term "business profits," the Technical Explanation states that the term is intended to cover income derived from any trade or business. As a result of the definitions of "enterprise" and "business" in Article 3, this definition includes income from independent personal services, which, unlike the present treaty but like the U.S. and OECD Model treaties, is not addressed in a separate article. Although the proposed treaty does not include a separate article for independent personal services, this article limits the right of a treaty country to tax income from the performance of personal services by a resident of the other treaty country in a manner similar to the limitations provided in the separate article applicable to independent personal services that is included in the present treaty.

The Technical Explanation discusses significant features of the definition of "business profits." The inclusion in business profits of income of an enterprise from personal services is consistent with the long-standing U.S. position that an enterprise's personal services income is business profits. Accordingly, a consulting firm resident in one treaty country whose employees or partners perform services in the other treaty country through a permanent establishment may be taxed in that other country under Article 7, and not under Article 14 (Income from Employment) because that article applies only to income of employees. The term "business profits" also includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is, according to the Technical Explanation, addressed in Article 20 (Other Income), unless specifically governed by another article.

The proposed treaty provides rules for the attribution of business profits to a permanent establishment. Under these rules, the treaty countries attribute to a permanent establishment the business profits that the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions, and dealing wholly independently with the enterprise of which it is a permanent establishment. For this purpose, the business profits to be attributed to the permanent establishment include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment. The proposed treaty and the Technical Explanation make clear that the principles of the OECD Transfer Pricing Guidelines apply for purposes of determining the profits attributable to a permanent establishment, but taking into account the different economic and legal circumstances of a single entity. The Technical Explanation notes that this rule confirms the arm's length standard for purposes of determining the profits attributable to a permanent establishment. Any of the methods described in the Transfer Pricing Guidelines, including profits methods, may be used to determine the income of the permanent establishment as long as those methods are applied in accordance with the Transfer Pricing Guidelines.

In applying the arm's-length standard to determine the taxable business profits of a permanent establishment, the Technical Explanation observes that it is necessary to draw an economic (as well as legal) distinction between operating through a single legal entity rather than through separate legal entities. For example, an entity that operates through branches rather than separate subsidiaries will have lower capital requirements because all of the assets of the entity are available to support all of the entity's liabilities (with some exceptions attributable to local regulatory restrictions). Thus, most commercial banks and some insurance companies operate through branches rather than subsidiaries. While the benefit that comes from such lower capital costs must be allocated among the branches in an appropriate manner, this issue does not arise in the case of an enterprise that operates through separate entities because each entity must either be capitalized separately or compensate another entity for providing capital (e.g., through a guarantee).

The Technical Explanation states that, whereas U.S. domestic law does not recognize internal transactions because they do not have legal significance, the rule provided by the proposed treaty is that such internal dealings may be used to allocate income in cases where the dealings accurately reflect the allocation of risk within the enterprise. For example, in the case of global dealing in securities, many banks use internal swap transactions to transfer risk from one branch to a central location where traders have the expertise to manage that particular type of risk. Under the proposed treaty, such banks also are permitted to use swap transactions as a means of allocating income between or among the branches, provided the allocation method used by the bank complies with the transfer pricing rules of U.S. internal law. However, the books of a branch will not be respected if the results are inconsistent with a functional analysis. For example, income from a transaction that is booked in a particular branch (or home office) would not be allocated to that location if the sales and risk management functions that generate such income are performed in another location.

A permanent establishment cannot be funded entirely with debt, but must have sufficient capital to carry on its activities as if it were a distinct and separate enterprise. In general, if insufficient capital has been attributed to a permanent establishment for profit attribution purposes, a treaty country may attribute such capital to the permanent establishment, in accordance with the arm's-length principle, and deny an interest deduction to the extent necessary to reflect that capital attribution. According to the Technical Explanation, both U.S. internal law and the proposed treaty start from the premise that all of the capital of the enterprise supports all of the assets and risks of the enterprise, and therefore the entire capital of the enterprise must be allocated to its various businesses and offices.

The Technical Explanation notes, however, that U.S. internal law[37] does not take into account the fact that some assets are more risky than other assets, and that, for example, an independent enterprise would require less capital to support a perfectly hedged U.S. Treasury security than it would to support an equity security or other asset with significant market and/or credit risk. Thus, U.S. internal law requires taxpayers in some cases to allocate more capital to the United States (and, thus, reduces the taxpayer's interest deduction more) than may be appropriate. To address these cases, the Technical Explanation states that the proposed treaty permits taxpayers to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it conducts business. In particular, with respect to financial institutions other than insurance companies, a treaty country may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. However, to ease the administrative burden arising because risk-weighting is more complicated than the method prescribed under U.S. internal law, the Technical Explanation also states that taxpayers may choose to apply the principles of U.S.

[37] Treas. Reg. sec. 1.882-5.

internal law, rather than risk-weighted attribution, even if the taxpayer has otherwise chosen to apply Article 7 in lieu of the effectively connected income rules of U.S. internal law.

The protocol to the proposed treaty provides a special rule with respect to profits attributable to Icelandic permanent establishments of U.S. insurance companies and U.S. permanent establishments of Icelandic insurance companies. The special rule provides that the provisions of Article 7 and Article 23 (Non-Discrimination) shall not prevent Iceland from continuing to tax permanent establishments of United States insurance companies in accordance with the Article 70, paragraph 2, section 3 of the Icelandic Tax Code, and shall not prevent the United States from continuing to tax permanent establishments of Icelandic insurance companies in accordance with section 842(b) of the Code. Section 842(b) provides that the amount of net investment income that is effectively connected with the conduct of an insurance business within the United States shall not be less than the product of (1) the assets required to support the U.S. insurance liabilities, and (2) the company's U.S. investment yield.

The proposed treaty provides that in computing taxable business profits of a permanent establishment, deductions are allowed for expenses, wherever incurred, that are for the purposes of the permanent establishment. These deductions include executive and general administrative expenses so incurred. The Technical Explanation states that deductions are allowed regardless of which accounting unit of the enterprise books the expenses, so long as the expenses are incurred for the purposes of the permanent establishment (including for the purposes of the enterprise as a whole or that part of the enterprise that includes the permanent establishment). The amount of expense that must be allowed as a deduction is determined by applying the arm's-length principle. The Technical Explanation states that a permanent establishment may deduct payments made to its head office or another branch in compensation for services performed for the benefit of the branch, provided the deduction comports to the arm's-length standard. The method for computing the amount of such a deduction would depend upon the terms of the arrangements between the branches and head office.

The Technical Explanation states that, if a deduction would be allowed under the Code in computing taxable income, the deduction is also allowed in computing taxable income under the proposed treaty. However, except where the proposed treaty provides for more favorable treatment, a taxpayer cannot take deductions for expenses in computing taxable income under the proposed treaty to a greater extent than would be allowed under the Code where doing so would be inconsistent with the intent of the Code. For example, if an Icelandic taxpayer with a permanent establishment in the United States borrows $100 to purchase U.S. tax-exempt bonds, and the bonds and related debt would be treated as assets and liabilities of the permanent establishment, both the tax-exempt interest from the bonds and the interest expense from the related debt would be excluded for purposes of computing the profits attributable to the permanent establishment under the proposed treaty.

Like the U.S. and OECD Model treaties, the proposed treaty provides that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise of which it is a part. According to the Technical Explanation, this rule applies only to an office that performs functions in addition to purchasing because purchasing does not by itself give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed.

When it applies, the rule provides that business profits may be attributable to a permanent establishment for its non-purchasing activities (e.g., sales activities), but not for its purchasing activities.

The proposed treaty requires that the determination of the business profits of a permanent establishment be made using the same method year by year unless there is a good and sufficient reason to the contrary. The Technical Explanation states that this rule limits the ability of both the treaty country and the enterprise to change accounting methods to be applied to the permanent establishment.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, generally govern the treatment of those items of income. Thus, for example, the taxation of dividends is determined under the rules of Article 10 (Dividends), and not by the rules of Article 7, except as specifically provided in Article 10 (that is, when dividends are attributable to a permanent establishment).

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed treaty the rule of section 864(c)(6) described above. This rule applies for purposes of the rules for business profits under this article, dividends (Article 10, paragraph 4), interest (Article 11, paragraph 3), royalties (Article 12, paragraph 4), gains (Article 13, paragraph 3) and other income (Article 20, paragraph 2).

The Technical Explanation notes that Article 7 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, in the case of the saving clause, if a U.S. citizen who is a resident of Iceland derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. tax.

## Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in paragraph 4 of Article 13 (Gains).

The United States generally taxes the U.S.-source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation or nonresident alien individual organized or resident in a foreign country that grants an equivalent exemption to U.S. corporations and residents. As a result of the present treaty, Iceland is considered to grant an equivalent exemption.[38]

Like the present treaty, the proposed treaty provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. Paragraph 6 of Article 7 (Business Profits) provides that if profits include items of income that are described in both Article 7 and other articles of the proposed treaty, including Article 8, the provisions of those other articles are not affected by the provisions of Article 7. The rules of Article 8, therefore, are not affected by the general rule of Article 7 that profits attributable to a permanent establishment that an enterprise of a treaty country has in the other treaty country may be taxed in the other treaty country. Consequently, the profits of an enterprise of a treaty country from the operation of ships or aircraft in international traffic may not be taxed in the other treaty country even if the enterprise has a permanent establishment in that other treaty country.

"International traffic" is defined in Article 3(1)(h) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in a treaty country.

The proposed treaty provides that profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft on a full basis (i.e., rental with crew, whether on a time or voyage basis). As in the U.S. Model treaty, profits from the operation of ships or aircraft in international traffic also include profits from the rental of ships or aircraft on a bareboat basis (that is, without crew), whether the ships or aircraft are operated in international traffic by the lessee or the rental income is incidental to the lessor's other profits from the operation of ships or aircraft in international traffic.

The proposed treaty provides that profits of an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic (and, therefore are governed by Article 8) if the transport is undertaken as part of international traffic. Thus, according to the Technical Explanation, if a U.S. enterprise contracts to carry property from Iceland to a U.S. city and as part of that contract transports the property by truck from its point of origin to an airport in Iceland (or contracts with a trucking company to carry the property to the airport), the income earned by the U.S. enterprise from the overland leg of the transport is taxable only in the United States. Similarly, the Technical Explanation states that Article 8 also applies to all income derived from a contract for the international transport of goods even if the goods are transported to the port by a lighter (a barge used in loading and unloading ships), and not by the vessel that carries the goods in international waters.

The proposed treaty provides that profits of an enterprise of a treaty country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic are taxable only in that treaty country. According to the Technical Explanation, this exclusive residence country taxation applies even if

[38] *See* Rev. Rul. 2008-17, 2008-12 I.R.B. 626 (Mar. 24, 2008).

the enterprise is not engaged in the operation of ships or aircraft in international traffic and even if the enterprise has a permanent establishment in the other treaty country.

As under the U.S. Model treaty, the shipping and air transport provisions of the proposed treaty apply to profits from participation in a pool, a joint business, or an international operating agency. These arrangements are common methods of cooperation among international shipping and air transport companies.

The Technical Explanation notes that Article 8 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Consequently, if a U.S. citizen who is a resident of Iceland derives profits from the operation of ships or aircraft in international traffic, the United States may tax those profits as part of the citizen's worldwide income (subject to the proposed treaty's foreign tax credit rules). The benefit of exclusive residence country taxation is available to an enterprise of a treaty country only if that enterprise satisfies the limitation on benefits requirements of Article 21.

## Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an enterprise of that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises. In such a case, a country may allocate to such an enterprise the profits that it would have accrued but for the conditions so imposed. This treatment is consistent with the U.S. and OECD Model treaties.

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

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, and the other country agrees with that redetermination, then that other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such a correlative, or corresponding, adjustment, the other provisions of the proposed treaty must be taken into account. For example, if the correlative adjustment is treated as a distribution of profits from a U.S. company for U.S. tax purposes, then the five-percent U.S. withholding tax, as provided by Article 10 (Dividends) of the proposed treaty, would apply to the correlative adjustment.

Based on a specific exception, the proposed treaty's saving clause, which retains full taxing jurisdiction in the country of residence or citizenship, does not apply in the case of correlative adjustments. Accordingly, the statute of limitations of a treaty country does not prevent the allowance of any appropriate correlative adjustments that may be necessary following an adjustment described in this article. For example, if a correlative adjustment would result in a refund, but the applicable statute of limitations for the refund claim has expired, the refund can still be made. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose additional tax, because paragraph 2 of Article 1 (General Scope) provides that the proposed treaty cannot restrict any statutory benefit.

## Article 10. Dividends

### Overview

The dividends article of the proposed treaty generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed treaty includes a generally applicable maximum rate of withholding at source of 15 percent and a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. A zero rate of withholding tax generally applies to dividends received by pension schemes and employee benefits organizations. Special rules apply to dividends received from RICs and REITs. These special rules are similar to provisions included in other recent treaties and protocols.

### Internal taxation rules

#### United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In that case, the foreign recipient is subject to U.S. tax on the dividends on a net basis at graduated rates in the same manner in which a U.S. person would be taxed.

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a U.S. domestic corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.[39] This distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.[40]

REITs generally are organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through to the REIT's shareholders the interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as both a corporation and as an entity not subject to corporate tax to the extent it distributes substantially all of its income. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, for taxable years beginning before January 1, 2008, net short-term capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution in a taxable year beginning before January 1, 2008 to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.[41]

---

[39] Because a REIT generally does not pay corporate-level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 15-percent rate available for individual shareholders.

[40] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

[41] The exception described in the immediately preceding footnote also applies for distributions by RICs.

A RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[42] generally may designate a dividend it pays in a taxable year beginning before January 1, 2008 as derived from that interest income, to the extent of that income. Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Iceland

Dividends paid by Icelandic resident companies to nonresident individuals and companies generally are subject to a 10-percent withholding tax.

Proposed treaty limitations on internal law

In general

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the payor company is resident, but the rate of tax is limited. Under the proposed treaty, source-country taxation of dividends (that is, taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividends is a company that owns directly at least 10 percent of the voting stock of the dividend-paying company.

The term "beneficial owner" is not defined in the proposed treaty and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country.

According to the Technical Explanation, however, special rules apply to companies holding shares through fiscally transparent entities, such as partnerships. In such cases, the rules of paragraph 6 of Article 1 (General Scope) of the proposed treaty apply to determine whether the dividends should be treated as derived by a resident of a treaty country. The laws of the residence country determine who derives the dividend, and the laws of the source country

[42] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

determine whether the person who derives the dividends is the beneficial owner of the dividends. The principles of paragraph 6 of Article 1 (General Scope) of the treaty also apply to determine whether other requirements have been satisfied, such as the ownership threshold that must be met to qualify for the 10-percent rate under this article.

The proposed treaty provides a zero rate of withholding tax for dividends received by a pension scheme or employee benefits organization, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the pension scheme or employee benefits organization. The proposed treaty defines a pension scheme as a plan, scheme, fund, trust, or other arrangement established in the United States or Iceland that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements and that is generally exempt from taxation in the treaty country in which it is established.

Dividends paid by U.S. RICs and REITs

The proposed treaty generally denies the five-percent rate of withholding tax to dividends paid by U.S. RICs and REITs.

The 15-percent rate of withholding generally is allowed for dividends paid by a RIC. The 15-percent rate of withholding is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (that is, the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rate are intended to prevent the use of RICs and REITs to gain inappropriate U.S. tax benefits. For example, a company resident in Iceland could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. Absent the additional RIC restrictions, there is a concern that such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at five percent).

Similarly, the Technical Explanation provides an example of a resident of Iceland that directly holds real property and is required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income from the property. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed treaty. The limitations on REIT dividend benefits are intended to protect against this result.

The proposed treaty also provides that the above rules apply to dividends paid by Icelandic companies that are similar to U.S. RICs and REITs. The determination of whether Icelandic companies are similar to U.S. RICs and REITs will be made by mutual agreement of the competent authorities.

Definitions and special rules and limitations

The proposed treaty generally defines dividends as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subject to the same tax treatment by the source country as income from shares (for example, constructive dividends).

The proposed treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country and the holding in respect of which the dividends are paid is effectively connected with that permanent establishment. In this case, the dividends are taxed as business profits (Article 7).

The proposed treaty prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country unless the dividends are paid to a resident of the first country or are attributable to a permanent establishment in that country.

The proposed treaty allows each treaty country to impose a branch profits tax on a company resident in the other country if the company has income attributable to a permanent establishment in that country, derives income from real property in that country that is taxed on a net basis under the treaty, or realizes gains taxable in that country under the treaty. In the case of the United States, the base of the tax is limited to the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (section 884). In the case of Iceland, the base of the tax is limited to an amount that is analogous to the dividend equivalent amount. The rate of branch profits tax is limited to five percent.

Relation to other articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 of the treaty (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 21 of the treaty (Limitation on Benefits).

## Article 11. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that satisfies specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level tax on certain “excess interest” of a U.S. trade or business of that corporation. Under this rule, an amount equal to the excess of the interest deduction allowed to the U.S. business over the interest paid by the business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if the interest (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (“REMIC”), the REMIC generally is treated for U.S. tax purposes as a pass-through entity, and the investor is subject to U.S. tax on a portion of the REMIC’s income (generally, interest income). If the investor holds a so-called “residual interest” in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor – referred to as the investor’s “excess inclusion” – may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor otherwise were eligible for such a rate reduction.

<u>Iceland</u>

Icelandic-source interest payments made to nonresident individuals and foreign corporations are not subject to tax in Iceland.

<u>Proposed treaty limitations on internal law</u>

The proposed treaty provides that interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty country generally is exempt from tax in the source country. This exemption from source-country tax is similar to that provided in the U.S. Model treaty and the present treaty. The present treaty, however, applies to interest derived by, rather than beneficially owned by, a resident of a treaty country.

The proposed treaty defines interest as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. The term “interest” also includes all other income that is treated as income from money lent under the tax law of the treaty country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

The exemption from source country taxation does not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. (The Technical Explanation describes interest as being "attributable to" the permanent establishment, a common usage in U.S. income tax treaties, rather than adopting the U.S. Model treaty's phrase that a debt-claim is "effectively connected with" a permanent establishment.) In that circumstance, the interest is taxed as business profits (Article 7). According to the Technical Explanation, interest attributable to a permanent establishment but received after the permanent establishment is no longer in existence is taxable in the country in which the permanent establishment existed.

The proposed treaty addresses non-arm's-length interest charges between a payer and a beneficial owner that have a special relationship. Paragraph 4 of Article 11 provides that the article applies only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country, with due regard being given to other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under a country's internal laws and, accordingly, would be entitled to the benefits of Article 10 (Dividends). The Technical Explanation notes that the term "special relationship" is not defined in the proposed treaty and states that the United States considers the term to include the relationships described in Article 9 (Associated Enterprises). Those relationships, according to the Technical Explanation, involve control as defined under the transfer pricing rules of section 482.

The proposed treaty provides two anti-abuse exceptions to the general source-country exemption from tax on interest. The first exception relates to contingent interest payments. If interest is paid by a source-country resident and is determined with reference to (1) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (2) any change in the value of any property of the debtor or a related person, or (3) any dividend, partnership distribution, or similar payment made by the debtor or a related person, the interest may be taxed in the source country in accordance with its laws. If the beneficial owner is a resident of the other treaty country, however, the interest may not be taxed at a rate exceeding 15 percent (that is, the rate prescribed in paragraph 2(b) of Article 10 (Dividends)).

The second anti-abuse exception provides that the exemption from source-country taxation does not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. That interest may be taxed by each treaty country in accordance with its domestic law. The Technical Explanation states that this exception is consistent with the policy of sections 860E(e) and 860G(b) that excess inclusions with respect to a REMIC should bear full U.S. tax in all cases.

The Technical Explanation notes that the benefits of Article 11, like benefits provided by other articles, are subject to the saving clause of paragraph 4 of Article 1 (General Scope) and are available only if a resident satisfies the limitation-on-benefits requirements of Article 21.

## Article 12. Royalties

### Internal taxation rules

#### United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

#### Iceland

Royalty payments made to nonresident companies are subject to tax on their net amount. Because the royalties are subject to withholding tax at the general corporate rate, any tax withheld is credited against the final tax liability.

### Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country are generally exempt from tax in the source country. This exemption from source country tax is similar to that provided in the U.S. Model treaty (except as noted below) and the present treaty. However, paragraph 2 of Article 12 (Royalties) provides an exception to the general rule. Specifically, certain royalties may still be taxed by the source country at a rate of up to five percent. Royalties that are subject to the withholding tax are those paid in consideration for the use of, or the right to use: (1) a trademark and any information concerning industrial, commercial or scientific experience provided in connection with a rental or franchise agreement that includes rights to use a trademark; and (2) a motion picture film or work on film, videotape or other means of reproduction for use in connection with television.

The term "royalties" as used in this article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including cinematographic films and computer software), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. As in the U.S. Model treaty, the term no longer includes payments made as consideration for "any like right or property," thereby narrowing the scope of the term.

Unlike the provision in the U.S. Model treaty, the term "royalties" does not include contingent gain from the alienation of any right or property described above. "Contingent gain" is gain contingent on the productivity, use, or disposition of the right or property. The treatment of such gain (as well as other gains from the alienation of such property) is addressed in Article 13 (Gains). The Technical Explanation states that the term royalties does not include income from leasing personal property.

The exemption from source country tax does not apply if the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, and the right or property with respect of which the royalties are paid is effectively connected with such permanent establishment. In that event, the royalties are taxed as business profits (Article 7).

According to the Technical Explanation, royalties attributable to a permanent establishment but received after the permanent establishment is no longer in existence remains taxable under the provisions of Article 7 (Business Profits), and not under Article 12.

In determining the source of royalties paid, paragraph 5 generally treats royalties as arising in the treaty country if they are paid by a resident of that country. An exception is carved out with respect to royalties that arise from the use of royalty-generating property by a permanent establishment located in a treaty country. If the expenses of such royalties are borne by the permanent establishment (i.e., they taken into account in determining taxable income of the permanent establishment), then they are considered to have arisen in that treaty country. If the payor is a resident of neither treaty country, but the royalties are paid with respect to the use of property in one of the treaty country, then the royalty will be considered as arising in the country of use.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length interest is taxable according to other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 (Dividends).

## Article 13. Capital Gains

### Internal taxation rules

#### United States

Generally, gain realized from the sale of a capital asset by a nonresident alien individual or a foreign corporation is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a sale by a nonresident alien individual, that individual is physically present in the United States for at least 183 days in the taxable year. A nonresident alien individual or foreign corporation generally is subject to U.S. tax on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations if U.S. real property comprises at least 50 percent of the assets of the corporation.

#### Iceland

Icelandic-source capital gains derived by nonresident companies on movable and immovable property and certain intangibles generally are subject to tax by Iceland. Icelandic-source capital gains derived by nonresident individuals on movable and immovable property generally are subject to tax by Iceland.

Proposed treaty limitations on internal law

The proposed treaty provides rules governing when a treaty country may tax gains from the alienation of property by a resident of the other treaty country. The rules generally are consistent with those included in the U.S. Model treaty.

Under the proposed treaty, gains derived by a resident of one treaty country that are attributable to the alienation of immovable property (real property) situated in the other country may be taxed in that other country. For the purposes of this article, immovable property (real property) situated in the other treaty country includes: (1) immovable property (real property) referred to in Article 6 (Income from Immovable Property (Real Property))—that is, an interest in the immovable property (real property) itself; (2) rights to assets to be produced by the exploration or exploitation of the sea bed and subsoil of that other treaty country and their natural resources, including rights to interests in, or the benefit of, such assets; (3) in the case of the United States, a U.S. real property interest; and (4) in the case of Iceland, (a) shares, including rights to acquire shares, that are not regularly traded on a stock exchange and that derive their value, or more than 50 percent of their value, directly or indirectly from immovable property (real property) situated in Iceland, and (b) an interest in a partnership or trust to the extent that the assets of that partnership or trust consist of immovable property (real property) situated in Iceland or shares described in (4)(a). Under U.S. internal law, a U.S. real property interest includes, among other property, shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-based test.

The proposed treaty includes a standard provision that permits a treaty country to tax gains from the alienation of movable property (that is, property other than immovable property (real property)) that forms a part of the business property of a permanent establishment that an enterprise of the other treaty country has in the first treaty country. This rule permits source-country taxation of gains from the alienation of the permanent establishment (alone or with the enterprise as a whole). According to the Technical Explanation, this taxation is permitted whether or not the permanent establishment exists at the time of alienation. Consequently, income that is attributable to a permanent establishment, but that is deferred and is received after the permanent establishment no longer exists, may nevertheless be taxed in the treaty country in which the permanent establishment was located. This rule is similar to a rule in U.S. internal law.

The Technical Explanation notes that a resident of Iceland that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership. Under the proposed treaty, the United States may tax the partner's distributive share of income realized by the partnership on the disposition of movable property forming part of the partnership's business property in the United States.

The proposed treaty provides that gains derived by an enterprise of one treaty country from the alienation of ships, aircraft, or containers operated or used in international traffic, or of personal property related to the operation of the ships, aircraft, or containers, are taxable only in that country. This rule applies even if the gains are attributable to a permanent establishment maintained by the enterprise in the other treaty country.

Gain from the alienation of any property other than the property described above is taxable under the proposed treaty only in the country in which the person alienating the property is a resident.

The proposed treaty includes a special rule that permits the imposition of certain expatriation taxes. This rule provides that gains derived by a resident of one treaty country from the alienation of shares or rights in a company resident in the other treaty country may be taxed in that other country if the person alienating the shares or rights was a resident of that other country at any time during the five-year period immediately preceding the alienation of such shares.

The Technical Explanation states that the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the proposed treaty had not come into effect. In addition, the benefits of this Article 13 are available only to a treaty country resident that satisfies one of the conditions in Article 21 (Limitation on Benefits). Finally, the provision allowing a treaty country to tax certain gains derived by a resident of the other treaty country from the alienation of shares or share rights shall be applied in conjunction with subparagraph 2(b) of Article 22 (Relief from Double Taxation).

**Article 14. Income from Employment**

Under the proposed treaty, salaries, wages, and other similar remuneration derived from services performed as an employee in one treaty country (the source country) by a resident of the other treaty country are taxable only by that person's country of residence if three conditions are met: (1) the individual is present in the source country for not more than 183 days in any 12-month period commencing or ending in the taxable year or year of assessment concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment of the employer in the source country (whether or not such expenses are actually deductible when determining the taxable income of the permanent establishment). These limitations on source country taxation are similar to the rules of the U.S. and OECD Model treaties.

The proposed treaty contains a special rule that permits remuneration derived by a resident of one treaty country with respect to employment as a regular member of the crew of a ship or aircraft operated in international traffic by an enterprise of the other treaty country to be taxed only in the first treaty country. A similar rule is included in the U.S. and OECD Model treaties. U.S. internal law does not impose tax on such income of a person who is neither a citizen nor a resident of the United States, even if the person is employed by a U.S. entity.

The Technical Explanation to the proposed treaty provides that it applies to compensation of any type, including payments in kind and stock options. Further, it applies without regard to the timing of the payment. Thus, a bonus paid to a resident of a treaty country with respect to services provided in the other treaty country would be subject to the terms of Article 14 (Income from Employment) even if the bonus is paid in a subsequent year.

This article is subject to the provisions of the separate articles covering directors' fees (Article 15), pensions, social security, and annuities (Article 17) and government service (Article

18). Thus, even though a treaty country may have the right to tax income from employment under this article, the right may be preempted if the income is also described, for example, in Article 18 (Government Service).

**Article 15. Directors' Fees**

Under the proposed treaty, director's fees and other similar payments derived by a resident of one country for services rendered in his or her capacity as a member of the board of directors of a company that is a resident of the other treaty country are taxable in that other treaty country. For this purpose, it is not relevant where the director performs such services. The Technical Explanation points out, however, that U.S. law will not tax the services of a nonresident alien unless such services are performed (1) within the United States, or (2) by a U.S. citizen that is nonresident. In the later case, such services may be taxed by the U.S. pursuant to paragraph 4 of Article 1 (General Scope), which preserves to each treaty country the right to tax its citizens and residents.

**Article 16. Entertainers and Sportsmen**

Article 16 of the proposed treaty addresses the taxation of services performed in a treaty country by entertainers and sportsmen resident in the other treaty country. The Technical Explanation provides that Article 16 applies to the income of an entertainer or sportsman who performs services both on his own behalf and on behalf of another person, either as an employee of that person or pursuant to any other arrangement. The article makes it possible to avoid the practical difficulties which often arise in taxing entertainers and sportsmen performing abroad. The rules of this article take precedence, in some circumstances, over those of Articles 7 (Business Profits) and 14 (Income from Employment).

In general

Paragraph 1 describes the circumstances in which a treaty country may tax the local performance income of an entertainer or sportsman who is a resident of the other treaty country. Under the paragraph, income derived by an individual resident of a treaty country from activities as an entertainer or sportsman exercised in the other treaty country may be taxed in that other country if the amount of the gross receipts derived by the performer for the taxable year exceeds $20,000 (or its equivalent in Icelandic kronur). The Treasury Explanation states that the determination as to whether the $20,000 threshold has been exceeded is determined separately with respect to each year of payment.

According to the Technical Explanation, the monetary threshold is designed to reach entertainers and athletes who are paid relatively large sums of money for very short periods of service, and who would, therefore, normally be exempt from host-country tax under the standard personal services income rules. The monetary threshold is consistent with the U.S. Model treaty.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Article 7 or 14. On the other hand, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those articles. For example, a performer who receives less than the $20,000 threshold amount and therefore is not taxable under Article 16 nevertheless may be subject to tax in the host country under Article 7 or 14 if the tests for host-country taxability under the relevant article are met.

Paragraph 5 of the protocol to the proposed treaty provides that a treaty country may withhold tax from payments subject to Article 16 according to its domestic laws. However, if according to the provisions of Article 16, such remuneration or income may only be taxed in the other treaty country, the first-mentioned country must refund the tax so withheld upon a duly filed claim.

The Technical Explanation provides that Article 16 applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a treaty country by a performer who is a resident of the other treaty country from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by Article 16, but by other articles of the treaty, such as Article 12 (Royalties) or Article 7. The Treasury Explanation provides that in determining whether income falls under Article 16 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property rights.

According to the Treasury Explanation, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases, there should be an apportionment between the performance-related compensation and other compensation.

Income accrues to another person

Paragraph 2 of Article 16 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but instead accrues to another person.

The relationship may truly be one of employee and employer, with no circumvention of paragraph 1 either intended or realized. On the other hand, the "employer" may, for example, be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the performance (a "star company"). The performer may act as an "employee," receive a modest salary, and arrange to receive the remainder of the income from his performance from the company in another form or at a later time. In such case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the dollar threshold in paragraph 1.

Paragraph 2 seeks to prevent this type of abuse. Under paragraph 2, when the income accrues to a person other than the performer, and the performer or related persons participate, directly or indirectly, in the receipts or profits of that other person, the income may be taxed in the treaty country where the performer's services are exercised, without regard to the provisions of the proposed treaty concerning business profits (Article 7). Taxation under paragraph 2 is imposed on the person providing the services of the performer. Paragraph 2 does not affect the rules of paragraph 1, which apply to the performer himself. According to the Technical Explanation, the income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1 or Article 7 or 14.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the performer) if that other person has control over, or the right to receive, gross income in respect of the services of the performer. Direct or indirect participation in the profits of a person may include, but is not limited to, the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income or other income, or distributions. The Treasury Explanation includes an example illustrating that the payment of salaries by a company to performers is not sufficient to establish that the performers participate in the profits of the company, where the performers receive their salaries out of the company's gross receipts.

Relationship to other articles

Article 16 is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in Iceland is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of Article16, subject to the foreign tax credit provisions of Article 22 (Relief From Double Taxation), including the special provisions in paragraph 4 of Article 22. In addition, the benefits of this article are subject to the provisions of Article 21 (Limitation on Benefits).

## Article 17. Pensions, Social Security, and Annuities

This article deals with the taxation of private pensions, social security benefits, annuities, and, to a limited extent, pension schemes, as defined in Article 3(l). This article does not cover payments of government pensions covered under Article 18 (Government Service).

Pension distributions

The proposed treaty includes the provision of the U.S. Model treaty under which pensions and other similar remuneration paid to a resident of a treaty country in consideration of past employment is taxable only in that country. The proposed treaty does not include the provision of the U.S. Model treaty that precludes the individual's country of residence from taxing the portion of pension income arising in the other country that would have been exempt in the source country if the beneficiary were a resident there. Consequently, Iceland may tax according to its internal tax law a distribution of a Roth IRA to a resident of Iceland. The proposed treaty also does not include the provisions of the U.S. Model treaty that address cross-border contributions to pension funds.

According to the Technical Explanation, the term "pensions and other similar remuneration" includes both periodic and lump sum payments and is intended to encompass payments made by qualified private retirement plans. According to the Technical Explanation, in the United States, the plans encompassed by "pensions and other similar remuneration" include: qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), section 403(a) qualified annuity plans, and section 403(b) plans. Distributions from section 457 plans may also meet this definition if they are not paid with respect to government services covered by Article 18. In Iceland, the term "pensions and other similar remuneration" applies to any pension fund or pension plan qualified under the Pension Act or any identical or substantially similar schemes which are created under any law enacted after the signature of the proposed treaty.

Pensions in respect of government services covered by Article 18 are not covered by the term "pensions and other similar remuneration." Such pensions are covered either by paragraph 2 of this article, if they are in the form of social security benefits, or by paragraph 2 of Article 18.

Timing of pension income and pension schemes

The proposed treaty provides that neither country may tax a resident of a treaty country on pension income earned through a pension scheme that is a resident of the other country until such income is distributed. When a resident receives a distribution from a pension fund, such distribution is subject to taxation in accordance with the provisions of this article (or if relevant, Article 18). For example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Iceland, Iceland is prevented from taxing currently that pension scheme's earnings and accretions with respect to that individual. Unlike the U.S. Model treaty, however, the proposed treaty does not address "rollover" distributions from a pension fund in one treaty country to a pension fund in the same country. Therefore, for example, Iceland may tax its residents on a rollover distribution from one U.S. pension fund to either another U.S. pension fund or an Icelandic pension fund.

The term "pension scheme" is defined in paragraph 1(l) of Article 3 (General Definitions) and means any plan, scheme, fund, trust or other arrangement established in a treaty country that (1) is generally exempt from income taxation in that country, and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. This definition is discussed in the description of Article 3.

Social security benefits

The proposed treaty, like the present treaty and the U.S. Model treaty, provides for exclusive source-country taxation of payments made under provisions of social security or "similar legislation." This provision is an exception to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of subparagraph 5(a) of Article 1. Thus, only Iceland and not the United States may tax Icelandic social security benefits paid to a U.S. citizen. The provision under the proposed treaty applies to both private sector and government employees. The term "similar legislation" is intended to refer to United States tier 1 Railroad Retirement benefits.

Annuities

The proposed treaty also provides that annuities (other than those paid for services rendered) derived and beneficially owned by an individual resident of either country are taxable only in the recipient's country of residence. This is similar to the rule in the U.S. Model treaty.

The term "annuities" is defined for purposes of this provision as a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered). The Technical Explanation states that an annuity received in consideration for services rendered would be treated either as deferred compensation and generally taxable in accordance with Article 14 (Income from Employment) or as a pension subject to the pension rules of this article.

Alimony and child support

Unlike the U.S. Model treaty, the proposed treaty does not expressly address the treatment of alimony and child support payments. Therefore, both are treated as other income that is subject to residence-country taxation under Article 20 (Other Income). In general, this is the same treatment for alimony as under the present treaty. Under the U.S. Model treaty, however, child support payments are exempt from tax in both treaty countries.

Saving clause

Paragraphs 1 and 3 of Article 17 are subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, for example, a U.S. citizen who is a resident of Iceland and receives a pension or annuity payment from the United States may be subject to U.S. tax on the payment, notwithstanding the rules in those paragraphs that give the recipient's country of residence the exclusive taxing right. Paragraphs 2 and 4 of Article 17 are excepted from the saving clause by virtue of subparagraph 5(a) of Article 1. Thus, the United States will not tax U.S. citizens and residents on the income described in those paragraphs even if such amounts otherwise would be subject to tax under U.S. law.

## Article 18. Government Service

Under paragraph 1 of Article 18 of the proposed treaty, remuneration, other than a pension, paid to an individual for services rendered to a treaty country (or political subdivision or local authority) is taxable only in that country. However, the remuneration is taxable only in the other country if the services are rendered there and the individual is a resident of that other country who is either a national of that other country or who did not become a resident of that other country solely for the purpose of rendering the services. According to the Technical Explanation, the provision applies to anyone performing services for a government, whether as an employee, an independent contractor, or an employee of an independent contractor.

Paragraph 2 of Article 18 covers any pension paid by, or out of funds created by, a treaty country that is not in the form of social security benefits and is in respect of government service rendered to a treaty county (or subdivision or authority) by an individual. Such a pension is taxable only in that country. However, such a pension is taxable only in the other country if the individual is both a resident and a national of the other country. According to the Technical Explanation, pensions paid to retired civilian and military employees of the government of either country are intended to be covered under paragraph 2.

When benefits paid by a treaty country in respect of services rendered to that country (or subdivision or authority) are in the form of social security benefits, those payments are covered by paragraph 2 of Article 17 (Pensions, Social Security, and Annuities). As a general matter, the result will be the same whether Article 17 or 18 applies, since both social security benefits and government pensions are taxable exclusively by the source country. According to the Technical Explanation, the result differs only when the payment is made to a citizen and resident of the other country, who is not also a citizen of the paying country. In such a case, social security benefits continue to be taxable at source while government pensions are taxable only in the residence country.

The treatment of payments described in paragraphs 1 and 2 of this article are subject to the provisions of those paragraphs and not to those of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen) or, except as noted above for social security payments, 17 (Pensions, Social Security, and Annuities). If, however, the remuneration or pension is paid for services performed in connection with a business carried on by a treaty country (or subdivision or authority), those other articles, and not Article 18, apply.

Under subparagraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to the benefits conferred by one of the treaty countries under Article 18 if the recipient of the benefits is neither a citizen of that country, nor a person who has been admitted for permanent residence (i.e., in the United States, a "green card" holder). As an example, the Technical Explanation states that a resident of a treaty country who in the course of performing functions of a governmental nature for that country becomes a resident of the other country (but not a permanent resident), would be entitled to the benefits of Article 18. The Technical Explanation states that, similarly, an individual who receives a pension paid by the Government of Iceland in respect of services rendered to the Government of Iceland shall be taxable on this pension only in Iceland unless the individual is a U.S. citizen or acquires a U.S. green card.

## Article 19. Students and Trainees

Under the proposed treaty, the treatment provided to students and business trainees is similar to the provisions of the U.S. Model treaty and the OECD Model treaty.

Under the proposed treaty, an individual resident of one treaty country who visits the other treaty country ("host country") will be exempt from income tax in the host country on certain payments received if the primary purpose of the visit is: (1) to study at a university or other recognized educational institution in the host country; (2) to secure training required to qualify the individual to practice a profession or professional specialty; or (3) to study or perform research as the recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization.

With respect to students, the exempt payments are limited to those payments the individual receives for his or her maintenance, education, study, research, and training that come from sources abroad; grants, allowances, or awards; and income from personal services performed in the host country up to a limit of $9,000 or its Icelandic kronur equivalent. The exemption from income tax in the host country applies only for a period of five years from the time the visitor first arrives in the host country.

With respect to trainees, the individual must be a resident of one treaty country and temporarily present in the host country as an employee of, or under contract with, a resident of the first treaty country, and the primary purpose of the visit must be either to acquire technical, professional, or business experience from a person other than the employer or a person related to the employer or to study at a university or other recognized educational institution in the host country. The proposed treaty provides that such individuals are exempt from host country taxation on up to $9,000 (or its Icelandic kronur equivalent) in personal services income for a period of up to one year.

With respect to an individual resident of treaty country who visits the host country as a participant of a host-country government-sponsored program of training, research, or study, the individual will be exempt from host country taxation on up to $9,000 (or its Icelandic kronur equivalent) of income from personal services in respect of training, research, or study performed in the host country. To qualify for this exemption, the individual cannot be temporarily resident in the host country for more than one year.

## Article 20. Other Income

Article 20 assigns taxing jurisdiction over items of income beneficially owned by a resident of a contracting state and not dealt with in the other articles of the proposed treaty. The general rule is that such items are taxable only in the country of residence. This rule is similar to the rules in the U.S. and OECD Model treaties.

In order for an item of income to be "dealt with" in another article it must be the type of income described in the article and, in most cases, it must have its source in one of the treaty countries. For example, royalty income that is beneficially owned by a resident of a treaty county is "dealt with" in Article 12 (Royalties) if the royalty income arises in the other treaty country, but not if the royalty income arises in a third country. However, profits derived in the conduct of a business are "dealt with" in Article 7 (Business Profits) whether or not they have their source in one of the treaty countries.

According to the Technical Explanation, examples of types of items of income covered by Article 20 include income from gambling, punitive (but not compensatory) damages, and covenants not to compete. Article 20 also applies to income from a variety of financial transactions, where such income does not arise in the course of the conduct of a trade or business. Unlike the U.S. Model treaty, the proposed treaty does not specifically address alimony or child support. Accordingly, such items would be covered by Article 20.

Distributions from partnerships are not generally dealt with under Article 20 because partnership distributions generally do not constitute income. Under the Code, partners include in income annually their distributive share of partnership income, and partnership distributions themselves generally do not give rise to income. This would also be the case under U.S. law with respect to distributions from trusts. Trust income and distributions that, under the Code, have the character of the associated distributable net income would generally be covered by another article of the proposed treaty.

The general rule of residence taxation does not apply to income (other than income from immovable property (real property) as defined in paragraph 2 of Article 6) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment situated therein, and the income is attributable to such permanent establishment. In such a case, the provisions of Article 7 (Business Profits) will apply.

Article 20 is subject to the saving clause in paragraph 4 of Article 1 (General Scope). Accordingly, U.S. citizens who are residents of Iceland will continue to be taxable by the United States on income to which this article applies, including relevant third-country income. This article is also subject to the provisions of Article 21 (Limitation on Benefits). Thus, if a resident of Iceland earns income that falls within the scope of paragraph 1 of Article 21, but that is taxable by the United States under U.S. law, the income would be exempt from U.S. tax under the provisions of Article 20 only if the resident satisfies one of the tests of Article 21 for entitlement to benefits.

## Article 21. Limitation on Benefits

### In general

Article 21 of the proposed treaty includes rules that are similar to the limitation-on-benefits provisions included in other recent U.S. income tax treaties and protocols. These rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Iceland. The current treaty does not include a limitation-on-benefits provision.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Iceland as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to all the benefits accorded by the proposed treaty if the resident has any one of six listed attributes. The six attributes are that the resident is: (1) an individual; (2) one of the two treaty countries or a political subdivision or local authority of one of the two countries; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) a pension scheme or employee benefits organization that satisfies a beneficiaries test; (5) an organization that is established in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, even if all or part of its income or gains are exempt from tax under the residence country's domestic law; or (6) an entity that satisfies an ownership test and a base erosion test. A resident that has none of these six attributes may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

Special anti-abuse rules govern items of income derived from one of the treaty countries by an enterprise resident in the other treaty country in so-called "triangular cases." In addition, a special rule applies in certain cases in which a company that is resident in one treaty country, or a company that controls such a company directly or indirectly, has outstanding a class of shares entitling a shareholder to a disproportionate part of the company's income.

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Six attributes for qualification for all treaty benefits

Individual

Under the proposed treaty, an individual resident of the United States or Iceland is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed treaty provides that the United States and Iceland, and any political subdivision or local authority of either of the two countries, are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of the United States or Iceland is entitled to all treaty benefits if the principal class of its shares is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

The term "regularly traded" is not defined in the proposed treaty and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(4)(i)(B). Based on that provision, the Technical Explanation states that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the "regularly traded" requirement.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the Icelandic Stock Exchange; the stock exchanges of Amsterdam, Brussels, Copenhagen, Frankfurt, Hamburg, Helsinki, London, Oslo, Paris, Stockholm, Sydney, Tokyo, and Toronto; and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term "primarily traded" is not defined in the proposed treaty and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded in the company's country of residence if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares of which is regularly traded on a recognized stock exchange but which does not satisfy the primary trading test (that is, the requirement that a company's principal class of shares be primarily traded on a recognized stock exchange in the company's country of residence) may claim treaty benefits if it satisfies the management and control test—that is, if the company's primary place of management and control is in the treaty country of which it is a resident. A company's primary place of management and control is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if the staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test often has been interpreted to mean the place where the board of directors meets. Under the proposed treaty, by contrast, the management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the United States or Iceland. This rule allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the treaty.

Pension schemes and employee benefits organizations

A pension scheme or employee benefits organization is entitled to all the benefits of the proposed treaty if more than 50 percent of the organization's beneficiaries, members, or participants are individuals resident in either the United States or Iceland. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization.

Tax-exempt organizations

An organization established in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes is entitled to treaty benefits notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that country. The Technical Explanation notes that a tax-exempt organization other than a pension scheme or employee benefits organization qualifies for benefits without regard to the residence of its beneficiaries or members.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year at least 50 percent of each class of the entity's shares or other beneficial interests are owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, pension schemes or employee benefits organizations, or tax-exempt organizations. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension schemes or employee benefits organizations, or tax-exempt organizations. Arm's-length payments made in the ordinary course of business for services or tangible property, and certain payments in respect of financial obligations to a bank, do not count against the entity in determining whether the 50-percent threshold is reached.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the ownership and base erosion tests.

Derivative benefits rule

The proposed treaty includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty-country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement.

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value are owned directly or indirectly by seven or fewer persons who are residents of European Union member states, European Economic Area states, North American Free Trade Agreement parties, or European Free Trade Agreement parties (together, "qualifying countries") and satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the proposed treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed treaty's rules, described above, for individuals, governments, parent companies that meet the public company test, pension schemes or employee benefits organizations, and tax-exempt organizations. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would meet the proposed treaty's requirements for entitlement to treaty benefits as an individual, a government, a parent company that meets the public company test, a pension scheme or employee benefits organization, or a tax-exempt organization. Second, for income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the proposed treaty (the "tax rate test").

The Technical Explanation gives the following example to illustrate the operation of the tax rate test. A U.S. company is wholly owned by an Icelandic company that in turn is wholly owned by a Canadian company. Assume the Icelandic company otherwise satisfies the requirements of the five-percent rate dividend provision, and assume that if the Canadian company received a dividend directly from the U.S. company, the applicable dividend withholding tax rate under the U.S.-Canadian treaty would be five percent. Under these facts, the Canadian company would be a resident of a qualifying country under the rules described above because it would be entitled to a withholding tax rate at least as low as the applicable rate (five percent) under the proposed treaty.

A person satisfies the second criterion of the ownership requirement if the person is a U.S. or Icelandic resident entitled to treaty benefits under one of the rules described previously for individuals, governments, parent companies that meet the public company test, pension schemes or employee benefits organizations, or tax-exempt organizations. Under this rule, according to the Technical Explanation, an Icelandic individual qualifies with respect to an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The

Technical Explanation states that this criterion was included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or Icelandic company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a Icelandic company is owned by five companies that are residents of European Union member states and that satisfy the first criterion described previously (the applicable treaty rules and the tax rate test), and 10 percent of the Icelandic company is owned by a U.S. or a Icelandic individual, the Icelandic company still can satisfy the requirements of the ownership test of the derivative benefits rules.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not residents of qualifying countries is less than 50 percent of the company's gross income for the year, as determined in the company's country of residence.

Active business test

Under the proposed treaty, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, and (2) the income from the other country is derived in connection with or is incidental to that trade or business. The proposed treaty provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer.

The term "trade or business" is not defined in the proposed treaty. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the proposed treaty, when determining whether a resident of Iceland is entitled to the benefits of the proposed treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the laws of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed treaty provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country.

The proposed treaty provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by partnerships in which that person is a partner and activities conducted by persons "connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The triangular case

The proposed treaty provides a special anti-abuse rule that, according to the Technical Explanation, addresses an Icelandic resident's use of the following structure to earn interest income from the United States. The Icelandic resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Icelandic resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Icelandic resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Iceland and the third country, Iceland does not tax the income earned by the permanent establishment. Alternatively, Iceland may choose to exempt the income of the permanent establishment from Icelandic income tax. Consequently, the income is not taxed in Iceland or the United States, and is only lightly taxed in the third country.

Under the proposed treaty, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in Iceland and the third country is less than 60 percent of the tax that would have been payable to Iceland if the income were earned in Iceland and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision also applies to all types of income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies is subject to tax under the domestic law of the source state, notwithstanding any other provision of the proposed treaty.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, the triangular provision does not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or holding investments for the person's own account, unless the business is banking or securities activities carried on by a bank or a registered securities dealer).

The triangular provision applies reciprocally. However, the United States does not exempt the income of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Grant of treaty benefits by the competent authority

Under the proposed treaty, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted. The competent authority of the source country is required to consult with the competent authority of the residence country before denying treaty benefits under this provision.

Shares with a disproportionate part of a company's income

Under the proposed treaty, a special rule applies in cases in which a company that is resident in one treaty country, or a company that controls such a company directly or indirectly, has outstanding a class of shares subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements ("the disproportionate part of the income"). If more than 50 percent of those shares are owned by persons not entitled to treaty benefits under one of the rules described previously for individuals, governments, publicly traded companies and subsidiaries, pension schemes or employee benefits organizations, tax-exempt organizations, or entities that satisfy the ownership and base erosion tests, then treaty benefits do not apply with respect to the disproportionate part of the income.

## Article 22. Relief From Double Taxation

Internal taxation rules

United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign-source income. An indirect or "deemed-paid" credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

A fundamental premise of the foreign tax credit is that it may not offset U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions limit the foreign taxes that a taxpayer may claim as credits for the year to the amount of the taxpayer's U.S. tax liability attributable to its foreign-source income. The limitation is computed separately for "passive category income" and other income in order to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

Iceland

Individuals and companies resident in Iceland generally are taxed on their worldwide income. In the absence of a treaty, relief from double taxation of foreign-source income generally is provided in the form of a tax credit.

Proposed treaty

Overview

One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is addressed in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief where both Iceland and the United States still tax the same item of income. This article is not subject to the saving clause; the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.

U.S. tax relief for taxes paid to Iceland

Paragraph 1 of Article 24 generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes paid to Iceland, and will allow a U.S. corporation a deemed-paid credit when the U.S. corporation receives dividends from an Icelandic corporation in which the U.S. corporation owns 10 percent or more of the voting stock. The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as such law may be amended from time to time without changing the general principles of the proposed treaty provisions). This provision is similar to those found in the U.S. Model treaty and many U.S. tax treaties, and is consistent with U.S. law.

The proposed treaty provides that the taxes referred to in paragraphs 3(a) and 4 of Article 2 (Taxes Covered) will be considered income taxes for purposes of paragraph 1. The Technical Explanation states that this rule is based on the Treasury Department's review of Iceland's laws.

Subparagraph 2(a) contains a re-sourcing rule that applies for purposes of paragraph 1. Under subparagraph 2(a), an item of gross income (as determined under U.S. law) that is derived by a U.S. resident and that may be taxed by Iceland under the proposed treaty will be deemed to be income from sources in Iceland for U.S. foreign tax credit purposes. The Technical Explanation states that this re-sourcing rule is intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for taxes paid to Iceland when the proposed treaty assigns to Iceland primary taxing jurisdiction over an item of gross income.

In the case of a U.S.-owned foreign corporation, section 904(g)(10) may apply for purposes of determining the U.S. foreign tax credit with respect to income subject to this re-sourcing rule. Section 904(g)(10) generally applies the foreign tax credit limitation described above separately to re-sourced income. Furthermore, because the re-sourcing rule applies to gross income, not net income, U.S. expense allocation and apportionment rules continue to apply to income resourced under subparagraph 2(a).

Under subparagraph 2(b), the general re-sourcing rule described above does not apply in the case of certain gains. In particular, gains derived by an individual while the individual was a resident of the United States that are taxed by the United States in accordance with the proposed treaty, and that may also be taxed in Iceland solely by reason of paragraph 6 of Article 13 (Capital Gains), are deemed to be gains from sources in the United States. Paragraph 6 allows Iceland to impose tax on gain derived by a U.S. resident from the sale of stock in an Iceland company if the individual was a resident of Iceland in the course of the five-year period preceding the sale of the stock. The Technical Explanation states that the provisions of subparagraph 2(b) ensure that the United States does not bear, from a foreign tax credit standpoint, the cost of Iceland's expatriation tax. However, the taxes paid to Iceland are creditable income taxes for purposes of paragraph 1 of Article 24. Accordingly, subject to the limitations described above under "Internal taxation rules - United States," an individual may claim a U.S. foreign tax credit for the taxes paid to Iceland.

Iceland tax relief for taxes paid to the United States

Specific rules are provided in paragraph 3 under which Iceland, in imposing tax on its residents, provides relief for U.S. taxes paid by those residents. Subparagraph 3(a) provides that when a resident of Iceland derives income that, in accordance with the provisions of the proposed treaty, may be taxed in the United States, Iceland shall allow as a credit against Icelandic income taxes an amount equal to those taxes paid to the United States.

Subparagraph 3(b) limits the credit against Icelandic taxes to those taxes that are attributable to the income that has been taxed by the United States.

Subparagraph 3(c) provides that when a resident of Iceland derives income that, in accordance with the provisions of the proposed treaty, is taxable solely by the United States, Iceland shall allow a credit against Icelandic tax as limited in subparagraph 3(b). However, subparagraph 3(c) permits Iceland to include the income in the resident's tax base. The Technical Explanation states that the rule is similar to U.S. domestic law, which permits credits for foreign taxes paid, while at the same time taxing residents on worldwide income. Finally, subparagraph 3(c) provides that for purposes of paragraph 3, the U.S. taxes referred to in subparagraph 3(b) and paragraph 4 of Article 2 (Taxes Covered) are considered to be income taxes allowable as credits against Icelandic tax on income under paragraph 3 of Article 22.

U.S. citizens who are resident in Iceland

Paragraph 4 provides special rules for the tax treatment of certain types of income derived by U.S. citizens who are residents of Iceland. U.S. citizens, regardless of residence, are subject to United States tax on their worldwide income. The U.S. tax on the income of a U.S. citizen who is a resident of Iceland may exceed the U.S. tax that may be imposed under the proposed treaty on the income if it were derived by a resident of Iceland who is not a U.S. citizen. The Technical Explanation states that the provisions of paragraph 4 ensure that Iceland does not bear the cost of U.S. taxation of its citizens who are residents of Iceland.

Subparagraph 4(a) provides a special credit rule for Iceland that limits the amount of credit Iceland must allow a resident of Iceland. The rule applies to items of income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the proposed treaty if they had been received by a resident of Iceland who is not a U.S. citizen. The tax credit allowed by Iceland under paragraph 4 with respect to such items need not exceed the U.S. tax that may be imposed under the proposed treaty, other than U.S. tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 4 of Article 1 (General Scope).

For example, if a U.S. citizen resident in Iceland receives portfolio dividends from sources within the United States, the foreign tax credit granted by Iceland would be limited to 15 percent of the dividend – the U.S. tax that may be imposed under subparagraph 2(b) of Article 10 (Dividends) – even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship. With respect to interest income, Iceland would allow no foreign tax credit, because its residents are exempt from U.S. tax on interest income under the provisions of Articles 11 (Interest).

Subparagraph 4(b) eliminates the potential for double taxation that can arise because subparagraph 4(a) provides that Iceland need not provide full relief for the U.S. tax imposed on its citizens resident in Iceland. The subparagraph provides that the United States will credit the income tax paid or accrued to Iceland, after the application of subparagraph 4(a). It further provides that in allowing the credit of the taxes paid to Iceland, the United States will not reduce its tax below the amount that is creditable against Icelandic tax under subparagraph 4(a).

Since the income described in subparagraph 4(a) generally will be U.S. source income, special rules are required to re-source some of the income to Iceland in order for a taxpayer to be able to credit the tax paid to Iceland. This re-sourcing is provided for in subparagraph 4(c), which deems the items of income referred to in subparagraph 4(a) to be from foreign sources to the extent necessary to avoid double taxation under subparagraph 4(b).

The Technical Explanation contains examples illustrating the application of paragraph 4.

Relationship to other Articles

By virtue of subparagraph 5(a) of Article 1 (General Scope), Article 22 is not subject to the saving clause of paragraph 4 of Article 1. Thus, the United States will allow a credit to its citizens and residents in accordance with Article 22, even if such credit were to provide a benefit not available under the Code (such as the re-sourcing provided by paragraph 2 and subparagraph 4(c)).

## Article 23. Non-Discrimination

The proposed treaty includes a comprehensive nondiscrimination article. The article is similar to the nondiscrimination article in the U.S. Model treaty and to provisions that have been included in other recent U.S. income tax treaties.

In general, under the proposed treaty, neither treaty country is permitted to discriminate against nationals of the other country by imposing on those nationals more burdensome taxes than it would impose on its own comparably situated nationals in the same circumstances.[43] Not all instances of differential treatment are discriminatory. Differential treatment is permissible in some instances under this rule on the basis of tax-relevant differences (for example, the fact that one person is subject to worldwide taxation in a treaty country and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands).

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities.

As under the U.S. and OECD Model treaties, however, a treaty country is not obligated to grant residents of the other treaty country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities that it grants to its own residents.

Except in circumstances in which the anti-avoidance rules described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 4 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a treaty country to a resident of the other treaty country must be deductible under the same conditions as if those amounts had been paid to a resident of the first treaty country. The Technical Explanation states that the exception relating to paragraph 4 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus allowing United States to apply its earnings stripping rules.

Any debts of an enterprise of one treaty country to a resident of the other treaty country must, for purposes of determining the taxable capital of the enterprise, be deductible under the

[43] A national of one treaty country may claim protection under this article even if the national is not a resident of either treaty country. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in Iceland as a comparably situated Icelandic national.

same conditions as if they had been owed to a resident of the first treaty country. According to the Technical Explanation, this rule, which applies in computing capital tax, is consistent with the nondiscrimination provisions generally because those provisions, in contrast with the general purpose of the treaty, which is to cover only income taxes, apply to all taxes levied in either treaty country.

The nondiscrimination rules also apply to enterprises of one treaty country that are owned in whole or in part by one or more residents of the other treaty country. An enterprise of one treaty country the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other treaty country may not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, the Technical Explanation provides examples of Code provisions that are understood by the two countries not to violate the nondiscrimination provision of the proposed treaty, including the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, the rules that prevent foreign persons from owning stock in subchapter S corporations, and the rules that prevent foreign corporations from joining in filing consolidated returns with domestic corporations.

The proposed treaty provides that nothing in the nondiscrimination article may be construed as preventing either of the countries from imposing a branch profits tax as described in paragraph 8 of Article 10 (Dividends).

Notwithstanding the definition of taxes covered in Article 2 (Taxes Covered), Article 23 applies to taxes of every kind and description imposed by either country, or any political subdivision or local authority of that treaty country. The Technical Explanation states that customs duties are not regarded as taxes for this purpose.

The saving clause does not apply to the nondiscrimination article. Thus, a U.S. citizen who is a resident of Iceland may claim benefits in the United States under Article 23.

The protocol to the proposed treaty states that Article 23 (and Article 7 (Business Profits)) do not prevent Iceland from taxing permanent establishments of U.S. insurance companies in accordance with Article 70, paragraph 2, section 3 of the Icelandic Tax Code and do not prevent the United States from taxing the permanent establishments of Icelandic insurance companies in accordance with section 842(b) of the Code (which prescribes rules for the minimum net investment income treated as being effectively connected with the conduct of an insurance business in the United States).

**Article 24. Mutual Agreement Procedure**

The mutual agreement provision permits taxpayers to bring to the attention of the competent authorities problems that may arise under the proposed treaty and authorizes the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the proposed treaty. The saving clause of the proposed treaty does not apply to the mutual agreement procedure. Consequently, the United States may apply to a U.S. citizen or resident rules and definitions agreed to by the competent authorities under the mutual agreement procedure even if those rules and definitions differ from comparable provisions of the Code.

Under Article 24, a person who considers that the actions of one or both of the treaty countries cause that person to be subject to tax in a manner not in accordance with the provisions of the proposed treaty may, irrespective of internal law remedies or time limits for refund claims, present a case to the competent authority of either treaty country. Unlike the OECD Model treaty, the proposed treaty provides no time limit for when a case must be brought. This rule is the same as the rule in the U.S. Model treaty but, according to the Technical Explanation, is more generous than the rule in most U.S. tax treaties. Under most treaties, a taxpayer may bring a case only to the competent authority of the taxpayer's country of residence, citizenship, or nationality. The Technical Explanation notes that the more generous rule of the proposed treaty allows a U.S. permanent establishment of a corporation that is a resident of Iceland to ask the U.S. competent authority for assistance if it is subject to inconsistent treatment in the United States and Iceland.

The Technical Explanation notes that typical cases brought under the mutual agreement procedure will involve economic double taxation arising from transfer pricing adjustments but that other types of cases also may be brought. The Technical Explanation gives as an example a taxpayer who has received income that the source country has determined is deferred compensation and therefore is taxable in that country but which the taxpayer believes is a pension taxable only in the taxpayer's country of residence.

The proposed treaty provides that if an objection presented to a competent authority appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other treaty country, with a view to the avoidance of taxation that is not in accordance with the proposed treaty. The proposed treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations in the domestic law of either treaty country (for example, a country's applicable statute of limitations). The Technical Explanation notes that if a taxpayer has entered into a closing agreement with the United States before bringing a case to the competent authorities, the U.S. competent authority will do nothing other than endeavor to obtain a correlative adjustment from Iceland. Procedural limitations can be overridden, according to the Technical Explanation, only for the purpose of making refunds and not to impose additional tax.

The competent authorities of the treaty countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. In particular, the competent authorities may agree to: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the same characterization of particular items of income, including the same characterization of income that is assimilated to income from shares by the tax laws of one treaty country and that is treated as a different class of income in the other treaty country; (4) the same characterization of persons; (5) the same application of source rules with respect to particular items of income; (6) a common meaning of a term; and (7) the application of the provisions of each treaty country's domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the proposed treaty. The Technical Explanation clarifies that this list is a nonexhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. The list therefore does not grant any authority that is not otherwise provided by the rule that the competent authorities are to endeavor to resolve by mutual agreement any difficulties or doubts about the interpretation or application of the proposed treaty.

The proposed treaty provides that the competent authorities may consult together for the elimination of double taxation in cases not provided for in the proposed treaty.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. The Technical Explanation states that this provision makes clear that the competent authorities may communicate without going through diplomatic channels.

The Technical Explanation states that even after the proposed treaty has been terminated, a taxpayer may bring to the competent authorities a case involving a year for which the proposed treaty was in force.

The Technical Explanation addresses cases involving the taxing jurisdictions of more than two countries. The example given is where a parent corporation resident in country A engages in transactions with its subsidiaries in countries B and C. The Technical Explanation notes that if there is a complete network of treaties among the three countries, the competent authorities of those countries should be able to agree on a three-sided solution to a problem.

A person may seek relief under the mutual agreement procedure even if the person is not generally entitled to benefits under the limitation on benefits rules of the proposed treaty.

### Article 25. Exchange of Information and Administrative Assistance

The proposed treaty generally provides that the two competent authorities will exchange such information as is relevant in carrying out the provisions of the proposed treaty or in carrying out the provisions of the domestic laws of the two treaty countries concerning all taxes of any kind imposed by a treaty country. The rules described below are broadly similar to the information exchange and administrative assistance rules in the U.S. Model treaty.

This exchange of information is not restricted by paragraph 1 of Article 1 (General Scope). Accordingly, information may about persons who are residents of neither Iceland nor the United States may be requested and provided under this article. For example, according to the Technical Explanation, if a third-country resident has an Icelandic bank account and the U.S. IRS believes that funds in the account should have been, but have not been, reported to the IRS, the U.S. competent authority may request information from Iceland about the bank account even though the owner of the account is not the taxpayer under examination.

Exchange of information also is not restricted by Article 2 (Taxes Covered). The competent authorities may exchange information relating to, for example, U.S. estate and gift taxes, U.S. excise taxes, and Icelandic value added taxes.

The proposed treaty provides that information exchange relating to each treaty country's domestic law is authorized to the extent that taxation under that law is not contrary to the proposed treaty. According to the Technical Explanation, the competent authority of one treaty country may request information about a transaction from the competent authority of another treaty country even if the transaction to which the information relates is a purely domestic transaction in the requested country and information exchange about the transaction would not be undertaken to carry out the proposed treaty. As an example, the Technical Explanation states (referencing the OECD Model treaty) that if a U.S. company and an Icelandic company transact with one another through a company resident in a third country that has no treaty with the United States or Iceland, the U.S. and Icelandic competent authorities may, to enforce their internal rules, exchange information about prices their resident companies paid in their transactions with the third-country company.

The proposed treaty provides that exchange of information may include information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the proposed treaty. Consequently, the competent authorities may exchange information about collection cases, cases under civil examination or criminal investigation, and cases being prosecuted.

Any information exchanged under the proposed treaty must be treated as secret in the same manner as information obtained under the domestic laws of the treaty country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies, or to persons or authorities engaged in the oversight of those taxes (for example, according to the Technical Explanation, the tax-writing committees of Congress and the General Accounting Office). The persons or authorities receiving information must use the information only in the performance of their official roles. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

If information is requested by a treaty country in accordance with this article, the proposed treaty provides that the requested treaty country must obtain the information in the same manner and to the same extent as if the tax of the requesting country were the tax of the requested country and were being imposed by that country, notwithstanding that the requested country may not need the information at that time for purposes of administering its own tax rules. According to the Technical Explanation, this rule clarifies that the limitations on information exchange described below do not prevent a treaty country from requesting information from a bank or a fiduciary that the treaty country does not need for its own tax purposes.

As is true under the U.S. Model treaty and the OECD Model treaty, under the proposed treaty a country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country; to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country; or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The Technical Explanation notes, however, that if a treaty country is asked to provide information, it should provide the information even if its own statute of limitations period has expired for the issue to which the information relates. According to the Technical Explanation, the statute of limitations of the treaty country making the request should govern. The Technical Explanation also states that even if the limitations on information exchange mean that a treaty country is not obligated to supply information in response to a request from the other treaty country, the requested country may choose to supply the information if doing so does not violate its internal law.

The proposed treaty provides that if specifically requested by the competent authority of a treaty country, the competent authority of the other treaty country must provide information under this article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested country with respect to its own taxes.

Under the exchange of information rules, each treaty country must endeavor to collect on behalf of the other treaty country such amounts as may be necessary to ensure that treaty relief from taxation otherwise imposed by the other treaty does not inure to the benefit of persons not entitled to relief. The Technical Explanation provides the following example. If a U.S. payor of a portfolio dividend receives an IRS Form W-8BEN from the recipient of the dividend, the payor is permitted to withhold at the reduced treaty rate of 15 percent. If, however, the recipient is merely acting as a nominee of a third-country resident, the rule just described obligates Iceland to withhold and remit to the United States the additional tax that the U.S. payor should have collected. Neither treaty country, however, is obligated to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.

The proposed treaty provides that if a competent authority of a treaty country intends to send officials to the other treaty country to interview individuals or examine books and records with the consent of the persons being examined, that competent authority must notify the other treaty country's competent authority of its intent.

Under the protocol to the proposed treaty, the powers of each treaty country's competent authority to obtain information include the ability to obtain information held by financial institutions, nominees, or persons acting in agency or fiduciary capacities. This power does not encompass obtaining information that would reveal confidential communications between a client and an attorney, solicitor, or other legal representative, where the client seeks legal advice. The protocol also provides that the competent authorities have the power to obtain information about the ownership of legal persons. The protocol states that the competent authorities are able to exchange the information described in the protocol in accordance with the rules in Article 25. According to the Technical Explanation, the protocol prevents a treaty country from relying on the limitation on information exchange described above to argue that its domestic bank secrecy laws (or similar rules) override its general obligation to provide information.

**Article 26. Members of Diplomatic Missions and Consular Posts**

The proposed treaty contains the rule (also found in the U.S. Model treaty, the present treaty, and other U.S. tax treaties) that its provisions do not affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements. Accordingly, the proposed treaty will not preempt the exemption from tax that a host country may grant to the salary of diplomatic officials of the other country. The saving clause is not taken into account in the application of this article to host country residents (i.e., persons who are resident for purposes of the treaty) who are neither citizens nor lawful permanent residents (i.e., permanently resident for immigration law purposes) of the host country. Thus, for example, Icelandic diplomats who are considered residents of the United States for purposes of the treaty (but not for purposes of U.S. immigration law) are not made subject to U.S. tax by the proposed treaty.

**Article 27. Entry into Force**

The proposed treaty provides that the treaty is subject to ratification in accordance with the applicable procedures of each treaty country. Each treaty country is to notify the other in writing, through diplomatic channels, when it has completed the required procedures. Generally, the proposed treaty will enter into force on the date of the later of the notifications made through diplomatic channels regarding the completion of the required ratification procedures. The Technical Explanation clarifies the rule, stating the relevant date is the date of the later notice, and not the date on which the notice is received by the other treaty country.

With respect to withholding taxes, the provisions of the proposed treaty will have effect for amounts paid or credited on or after the first day of January in the first calendar following the year in which the proposed treaty enters into force. Thus, if the treaty enters into force on September 15, 2008, the withholding tax provisions have effect with respect to amounts paid or credited on or after January 1, 2009. Similarly, with respect to other taxes, the provisions of the proposed treaty will also have effect for taxes chargeable to tax periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

The proposed treaty provides that the present treaty generally ceases to have effect with respect to any tax or exchange of information as of the date the proposed treaty takes effect. However, taxpayers may elect to temporarily continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect if they would have been entitled to greater benefits under the present treaty. For such a taxpayer, the present treaty would continue to have effect, in its entirety, for a 12-month period from the date on which the provisions of the proposed treaty would otherwise take effect. In addition, teachers are granted a special grandfather provision. Pursuant to the grandfather clause, any individual that is entitled to benefits under Article 21 (Teachers) of the present treaty at the time the proposed treaty enters into force will continue to be entitled to the benefits available under the present treaty as if that treaty were still in force. The grandfather clause lasts as long as such individual would have been entitled to the previously existing benefits.

**Article 28. Termination**

This article provides that the proposed treaty is to remain in effect indefinitely, unless terminated by one of the treaty countries. The treaty may be terminated at any time by giving notice, through the appropriate diplomatic channels, at least six months in advance before the end of any calendar year. If notice of termination is given, the provisions of the treaty with respect to withholding at the source will cease to have effect on January 1 of the next calendar year. Similarly, for other taxes, the treaty will cease to have effect for taxes chargeable with respect to the tax periods commencing on or after January 1 of the next calendar year. For example, if notice of termination is given on May 1, 2015, then provisions of the treaty with respect to withholding at source will cease to have effect on January 1, 2016. For calendar year companies, the treaty will cease to have effect for taxes chargeable to the tax period commencing January 1, 2016. However, for any company with a November 30 fiscal year end, the treaty will cease to have effect for taxes chargeable to the tax period commencing December 1, 2016.

# VI. DISCUSSION

## A. Students and Trainees

**Treatment under proposed treaty**

Under the proposed treaty, an individual resident of one treaty country who visits the other treaty country ("host country") will be exempt from income tax in the host country on certain payments received if the primary purpose of the visit is: (1) to study at a university or other recognized educational institution in the host country; (2) to secure training required to qualify the individual to practice a profession or professional specialty; or (3) to study or perform research as the recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization.

With respect to students, the exempt payments are limited to those payments the individual receives for his or her maintenance, education, study, research, and training that come from sources abroad; grants, allowances, or awards; and income from personal services performed in the host country up to a limit of $9,000 or its Icelandic kronur equivalent. The exemption from income tax in the host country applies only for a period of five years from the time the visitor first arrives in the host country.

With respect to trainees, the individual must be a resident of one treaty country and temporarily present in the host country as an employee of, or under contract with, a resident of the first treaty country, and the primary purpose of the visit must be either to acquire technical, professional, or business experience from a person other than the employer or a person related to the employer or to study at a university or other recognized educational institution in the host country. The proposed treaty provides that such individuals are exempt from host country taxation on up to $9,000 (or its Icelandic kronur equivalent) in personal services income for a period of up to one year.

With respect to an individual resident of treaty country who visits the host country as a participant of a host-country government-sponsored program of training, research, or study, the individual will be exempt from host country taxation on up to $9,000 (or its Icelandic kronur equivalent) of income from personal services in respect of training, research, or study performed in the host country. To qualify for this exemption, the individual cannot be temporarily resident in the host country for more than one year.

**Issues**

The proposed treaty generally has the effect of exempting certain payments from the income tax of both treaty countries. The exempt payments are those arising outside the host country that are received for the maintenance, education, and training of full-time students and full-time trainees as visitors from one treaty country to the other. This exemption conforms to the U.S. Model treaty and the OECD Model treaty provisions. Under the proposed treaty, full-time students and trainees may also earn up to $9,000 U.S. dollars or its Icelandic kronur equivalent annually in tax-free personal services income. This personal service income exemption is similar to a provision in the U.S. Model treaty but departs from the OECD Model treaty. Under section 911, a U.S. citizen or resident may elect to exclude $87,600 of non-U.S. source earned income attributable to personal services performed by the citizen or resident.[44] Section 911 in conjunction with the proposed treaty provision allows a U.S. student studying in Iceland to receive remuneration of up to $9,000 of income from personal services tax free. Similarly, if Iceland exempts labor income earned abroad from Icelandic tax, an Icelandic student studying in the United States could receive up to $9,000 of income from personal services tax free. By enabling a student to earn some income tax free, this provision generally would have the effect of reducing the cost of education and training received by visitors, which may encourage individuals to consider study abroad in the other treaty country. Such cross-border visits by students and trainees may foster the advancement of knowledge and redound to the benefit of residents of both countries.

In the case of business trainees, the proposed treaty limits the exemption for such payments to a period of one year or less. By potentially subjecting such payments made beyond those received during the first 12 months of a visit to host country income tax, the cost for cross-border visitors of engaging in such longer duration training programs would be increased. This increased cost may discourage visitors to such programs in either country. It could be argued that the training of a business trainee relates primarily to specific job skills of value to the individual or the individual’s employer rather than enhancing general knowledge and cross-border understanding, as may be the case in the education of a full-time student. This could provide a rationale for providing more open-ended treaty benefits in the case of students as opposed to business trainees. However, this rationale raises a question as to why training requiring one year or less is preferred to training that requires a longer visit to the host country. As such, the proposed treaty would favor certain types of training arrangements over others. The OECD Model treaty does not limit the duration of exemption for payments for maintenance, education, and training for business trainees; the U.S. Model treaty limits the exemption to a period not exceeding one year.

[44] The $87,600 exemption amount for 2008 is indexed for inflation. Code sec. 911(b)(2)(D); Rev. Proc. 2007-66, sec. 3.30, 2007-45 I.R.B. 970.

## B. Limitation on Benefits

**In general**

The proposed treaty includes limitation-on-benefits rules that are similar to the limitation-on-benefits rules in other recent U.S. income tax treaties; in the proposed treaty with Bulgaria and the proposed protocol with Canada; and in the U.S. Model treaty. These rules are intended to prevent the indirect use of the U.S.-Iceland income tax treaty by persons who are not entitled to its benefits by reason of residence in the United States or Iceland.

When a resident of one country derives income from another country, the internal tax rules of the two countries may cause that income to be taxed in both countries. One purpose of a bilateral income tax treaty is to allocate taxing rights for cross-border income and thereby to prevent double taxation of residents of the treaty countries. Although a bilateral income tax treaty is intended to apply only to residents of the two treaty countries, residents of third countries may attempt to benefit from a treaty by engaging in a practice known as "treaty shopping." Treaty shopping may involve investing in one treaty country through an entity organized in the other treaty country to obtain the benefits of the treaty, or engaging in income-stripping transactions with a treaty-country resident. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping.

The present treaty between the United States and Iceland is one of only eight U.S. income tax treaties that do not include any limitation-on-benefits rules. Three of those eight treaties, including the treaties with Iceland, Hungary, and Poland, include provisions providing for complete exemption from withholding on interest payments from one treaty country to the other treaty country. Consequently, those three treaties may present attractive opportunities for treaty shopping. In fact, a November 2007 report prepared by the Treasury Department at the request of the U.S. Congress suggests that the income tax treaties with Hungary and Iceland have increasingly been used for treaty-shopping purposes as the United States adopted modern limitation-on-benefits provisions in its other treaties.[45] With its inclusion of modern limitation-on-benefits rules, the proposed treaty represents a significant opportunity to eliminate a treaty-shopping opportunity. Nevertheless, the Committee may wish to inquire of the Treasury Department as to its plans to address the remaining U.S. income tax treaties that do not include limitation-on-benefits provisions, particularly Hungary and Poland.

---

[45] Department of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Nov. 28, 2007). The report states that, as of 2004, it does not appear that the U.S.-Poland income tax treaty has been extensively exploited by third-country residents.

The cross-border investment data discussed in section IV.B above might also suggest that foreign persons are increasingly investing in the United States through Iceland to obtain treaty benefits. For example, the value of U.S. direct investments held by Icelandic persons increased from $2.2 billion in 2003 to $7.4 billion in 2005; in contrast, the value of Icelandic direct investments held by U.S. persons averaged $4 million during the period 2002 through 2005.

In addition, although the limitation-on-benefits rules in the proposed treaty are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. Model treaty, they are not identical, and the Committee may wish to inquire about certain differences. In particular, the Committee may wish to examine the rules for derivative benefits and certain triangular arrangements.

Finally, the Committee may wish to inquire about the unusual entry-into-force provision of the proposed treaty. That provision offers persons seeking treaty benefits an election to apply either the present treaty or the proposed treaty for a 12-month period following the date on which the proposed treaty would otherwise enter into force.

**Derivative benefits**

Like the proposed treaty with Bulgaria and the proposed protocol with Canada, and like other recent treaties, the proposed treaty includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly.

The derivative benefits rules may grant treaty benefits to a treaty-country resident company in circumstances in which the company would not qualify for treaty benefits under any of the other limitation-on-benefits provisions. The U.S. Model treaty does not include derivative benefits rules. The Committee may wish to inquire about the circumstances that justify inclusion of these rules in new treaties notwithstanding their absence from the U.S. Model treaty.

**Triangular arrangements**

The proposed treaty includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which an Icelandic-resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Iceland. Similar anti-abuse rules are included in other recent treaties and in the proposed treaty with Bulgaria. The U.S. Model treaty, however, does not include rules addressing triangular arrangements. The Committee may wish to ask the Treasury Department why these anti-abuse rules are not included in the U.S. Model treaty. Moreover, in light of their absence from the U.S. Model treaty, the Committee may wish to inquire whether the Treasury Department will insist on inclusion of such anti-abuse rules whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty-country resident.

**Entry into force**

The proposed treaty includes an unusual rule that allows a person to claim benefits under the present treaty even after the proposed treaty has gone into effect. This election is available to any person entitled to benefits under the present treaty who would have received greater benefits under that treaty than that person would receive under the proposed treaty. This election is available for the 12-month period beginning on the date on which the provisions of the proposed treaty would otherwise have effect. This rule is not included in the proposed protocol with Canada, the U.S. Model treaty, or other recent treaties.

The Committee may wish to ask the Treasury Department about the circumstances that justify inclusion of this election in the proposed treaty when doing so allows a person to unilaterally determine whether that person may continue to claim benefits under a treaty that the United States and Iceland have otherwise replaced. On the one hand, this election may give persons who would not otherwise qualify for treaty benefits under the proposed treaty additional time to restructure their investments so as to qualify for treaty benefits under the proposed treaty. On the other hand, this election may allow persons who cannot, and will not, satisfy the limitation-on-benefits rules of the proposed treaty to continue to claim treaty benefits for an entire year after the proposed treaty has gone into effect.