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INCOME TAX CONVENTION AND PROTOCOL WITH PORTUGAL

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Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 103–34, 103d Congress, 2d Session]

The Committee on Foreign Relations, to which was referred the Convention between the Government of the United States of America and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, together with a related protocol, signed in Washington, on September 6, 1994, having considered the same, reports favorably thereon, without amendment, and recommends that the Senate give its advice and consent to ratification thereof, subject to two understandings and two declarations as set forth in this report and the accompanying resolution of ratification.

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and the Portuguese Republic ("Portugal") are to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping tax jurisdictions of the two countries. It is also intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

II. BACKGROUND

The proposed treaty and the proposed protocol were signed on September 6, 1994 and were amplified by an exchange of notes

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dated October 7, 1994. No income tax treaty is currently in force between the United States and Portugal.

The proposed treaty and protocol were transmitted to the Senate for advice and consent to its ratification on September 19, 1994 (see Treaty Doc. 103-34). The Committee on Foreign Relations held a public hearing on the proposed treaty and protocol on June 13, 1995.

III. SUMMARY

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty[1] (the "U.S. model"), and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains some deviations from these documents.

As in other U.S. tax treaties, the objectives are achieved principally by each country agreeing 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 provides that a country will not tax business income derived from sources within that country by residents of the other country unless the business activities in the first country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 15). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country are not required to pay tax in that other country unless their contact with that country exceeds specified minimums (Articles 15, 16, and 19). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally are taxable by both countries (Articles 10, 11, 13 and 14). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11 and 13).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief of the potential double taxation by requiring the country of residence either to grant a credit against its tax for the taxes paid to the second country or to exempt that income (Article 25).

The proposed treaty contains a "saving clause" similar to that contained in other U.S. tax treaties (Article 1, as modified by paragraph 1 of the proposed protocol). Under this provision, the United States generally retains the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the proposed protocol contains the standard provision that it does not apply to deny a taxpayer any benefits he is entitled to under the domestic

[1] The U.S. model has been withdrawn from use as a model treaty by the Treasury Department. Accordingly, its provisions may no longer represent the preferred position of U.S. tax treaty negotiations. A new model has not yet been released by the Treasury Department. Pending the release of a new model, comparison of the provisions of the proposed treaty against the provisions of the former U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties.

law of the country or under any other agreement between the two countries (paragraph 1(a)); that is, the treaty only applies to the benefit of taxpayers.

The proposed treaty also contains a nondiscrimination provision (Article 26) and provides for administrative cooperation and exchange of information between the tax authorities of the two countries to avoid double taxation and to prevent fiscal evasion with respect to income taxes (Articles 25 and 28).

The proposed treaty differs in certain respects from other U.S. income tax treaties, and from the U.S. model and OECD model treaties. A summary of the provisions of the proposed treaty and protocol, including some of these differences, follows:

(1) The proposed treaty generally applies to residents of the United States or Portugal (Article 1), and applies to U.S. and Portuguese income taxes (Article 2).

(2) The U.S. model specifically does not limit the application of the accumulated earnings tax and the personal holding company tax. The proposed protocol (paragraph 2) provides for limited exemptions from these taxes. With respect to the personal holding company tax, a Portuguese company is granted exemption for a taxable year only if all of its stock is owned for the entire taxable year by one or more individuals who are neither U.S. residents nor U.S. citizens. In the case of the accumulated earnings tax, exemption is granted to a Portuguese company only if it meets the publicly traded company exception contained in the article on limitation on benefits (paragraph 1(c) of Article 17) of the proposed treaty.

Unlike the U.S. model treaty, but like many U.S. treaties, the proposed treaty does not cover the U.S. excise tax on premiums paid to foreign insurers.

(3) The definition of the term "United States" as contained in the proposed treaty (Article 3) generally conforms to the definition provided in the U.S. model. In both definitions, the term generally is limited to the United States of America, thus excluding from the definition U.S. possessions and territories. In addition, the proposed treaty makes it clear that each country includes its continental shelf, whereas the U.S. model is silent with respect to this point. The term "Portugal" is defined to include the archipelagoes of Azores and Madeira.

(4) U.S. citizens who are not also U.S. residents are not generally covered by the proposed treaty (Article 4). The U.S. model does cover such U.S. citizens. The United States rarely has been able to negotiate coverage for nonresident citizens, however.

(5) Both the proposed treaty (Article 4) and the U.S. model provide that a person who is taxable under the laws of a country by reason of that person's residence is considered a resident of that country for treaty purposes. Paragraph 3(c) of the proposed protocol limits the application of this rule in the case of certain persons who are treated as U.S. residents under the Internal Revenue Code ("Code"). That provision, like those of some recent U.S. tax treaties, states that a U.S. citizen or alien admitted to the United States for permanent residence (i.e., a "green card" holder) is considered a resident of the United States for purposes of the proposed treaty only if that individual either has a substantial presence in the

United States or would be a U.S. resident (and not a resident of another country) under the criteria of the tie-breaker rule, which deals with the place of a person's permanent home, center of vital interests, and habitual abode. This provision of the proposed protocol is to be administered in the same order of priority as specified in the tie-breaker rule.

(6) The proposed treaty, unlike the U.S. model, does not treat a dual resident company (i.e., a company that is a resident of both treaty countries) as a resident of the country under whose laws it was created. Under the proposed treaty, if the competent authorities are unable to mutually agree upon the residence of a dual resident company, such a company is to be treated as a resident of neither the United States nor Portugal for purposes of enjoying treaty benefits (Article 4(3)).

Similarly, whereas the U.S. model requires a competent authority determination (on the basis of mutual agreement) on the mode of application of the treaty to a person other than an individual or a company that is a dual resident, no such requirement is found in the proposed treaty. Such a person is treated in the same manner as a company under the proposed treaty. Thus, if the competent authorities are unable to mutually agree upon the residence of such a person, such person will be treated as a resident of neither the United States nor Portugal under the proposed treaty. Similar rules for dual resident companies (and for persons other than individuals or companies that are dual residents) are contained in the U.S. treaties with Mexico and Germany.

(7) Article 5 of the proposed treaty contains a definition of the term "permanent establishment" which, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model. For instance, under the proposed treaty, a building site or construction or installation project or assembly project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources (or related supervisory activity) that an enterprise of one country has in the other country will constitute a permanent establishment in that other country if it lasts more than six months. This six-month period is significantly shorter than the 12-month period provided in the U.S. model.

(8) The proposed treaty contains a provision not found in the OECD model, the U.S. model, or many other U.S. treaties. The special provision, applicable to the first 5 years that the proposed treaty is in effect, deems an enterprise to have a permanent establishment in a country if its employees or other personnel carry on business of a permanent nature in the other country for an aggregate period of 9 months in any 12-month period which begins or ends during the tax year (Article 5(4); proposed protocol paragraph 4). The enterprise in this case is not required to have a fixed place of business in the other country. The term "business of a permanent nature" is not defined in the proposed treaty. The Treasury Department Technical Explanation of the Convention and Protocol Between the United States of America and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income Signed at Washington on September 6, 1994 ("Technical Explanation") states that the term

is intended to suggest activities other than that of a preparatory or auxiliary character. This provision is similar to, but more limited than, a corresponding provision in some other U.S. tax treaties (e.g., the U.S. treaties with the Czech Republic and Slovakia).

(9) The proposed treaty contains a provision similar to the corresponding model treaty provision permitting taxation of income from real property by the country in which the real property is located (Article 6). Unlike the U.S. model treaty and most U.S. treaties, but like the OECD model treaty and several recent treaties, Article 6 of the proposed treaty defines real property to include accessory property, as well as livestock and equipment used in agriculture and forestry. Unlike the model treaties and other U.S. treaties, paragraph 5 of the proposed protocol also permits the country where the real property is located to tax income from associated personal property and from the provision of services for the maintenance or operation of real property.

(10) The proposed treaty omits the standard treaty provision found in the U.S. model which provides investors in real property in the country not of their residence with an election to be taxed on such investments on a net basis. The OECD model does not provide for such a net-basis election. Current U.S. law independently provides a net-basis taxation election to foreign persons for U.S. real property income (Code secs. 871(d) and 882(d)). The Technical Explanation states that Portugal taxes real property income on a net basis if the property is attributable to a permanent establishment or fixed base and such income is part of the business income of such permanent establishment or fixed base. Otherwise, the income arising from that property is considered passive investment income under Portuguese law and is subject to a 25-percent gross basis withholding tax.

(11) The proposed treaty provides clarification in a number of instances with respect to the ability of a country to tax profits derived by a business enterprise or derived from the performance of independent personal services. Specifically, the proposed treaty states that such profits may, in certain cases, be taxed by a country in which an enterprise carries on or has carried on business (Article 7(1)) or where a person performs or has performed services (Article 15(1)). This clarifies that Code section 864(c)(6) is not overridden by the proposed treaty.

(12) The proposed treaty does not contain a definition of the term "business profits" (which are generally taxed on a net basis), although certain categories of business profits are defined in various articles. Although the OECD model does not contain a definition of business profits, many U.S. treaties, and the U.S. model, define the term business profits to include income from rental of tangible personal property and from rental or licensing of films or tapes. The proposed treaty (Article 13(3)) includes payments for the use of, or the right to use, these specific items as royalties, which generally are subject to a 10-percent source-country withholding tax imposed on a gross basis.

The proposed protocol contains a provision (paragraph (6)) not found in the OECD model, the U.S. model, or many other U.S. treaties that allows the United States or Portugal to apply its own internal law to attribute research and development expenses, inter-

est, and other similar expenses to a permanent establishment within its territory. The Technical Explanation states that this provision confirms the ability of the United States to apply its expense allocation rules under Treas. Reg. secs. 1.861–8 and 1.882–5 in determining the expenses allocable to a U.S. permanent establishment of a Portuguese corporation.

(13) Article 8 of the proposed treaty, similar to the model treaties, generally provides that income of a resident of one treaty country from the operation of ships or aircraft in international traffic is taxable only in that country. Unlike the U.S. model, however, as clarified in paragraph 7 of the proposed protocol, the proposed treaty does not include bareboat leasing income in the category of income to which this rule applies; following the OECD model treaty and the published commentaries thereto, income from bareboat leasing that is not occasional and incidental to the lessor's international shipping operations would be treated as royalties, and subject to taxation in the source country on a gross basis unless attributable to a permanent establishment. Under paragraph 11 of the proposed protocol, the gross basis tax applicable to such royalties would be zero. Thus, income from container leasing would be exempt from source country taxation unless attributable to a permanent establishment.

(14) Similar to the OECD model, the article on associated enterprises (Article 9) of the proposed treaty omits the provision found in the U.S. model treaty and in most other U.S. treaties which clarifies that neither treaty country is precluded from (or limited in) the use of any domestic law which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of one of the treaty countries, owned or controlled directly or indirectly by the same interests, where necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons. However, the Technical Explanation indicates that the United States is entitled under the proposed treaty to utilize the rules of Code section 482 in cases where it is necessary to reallocate profits among related enterprises to reflect results which would prevail in a transaction between independent enterprises, so long as the application of these rules is consistent with the general arm's-length principles of Article 9.

When a redetermination of tax liability has been properly made by one country, and the competent authorities of the other country agree to its propriety then that other country shall make an appropriate adjustment to the amount of tax paid on the redetermined income. This "correlative adjustment" clause is similar to the corresponding U.S. model treaty language which is understood to require a correlative adjustment only to the extent that the other country agrees with the original adjustment by the first country. In making this adjustment, due regard is to be given to the other provisions of the proposed treaty and protocol and, if necessary, the competent authorities of the two countries are to consult with one another.

(15) The proposed treaty's limit on the gross-basis dividend withholding tax rates that the country of source may impose with respect to direct dividends differs from those of the U.S. model. Both

treaties provide for two levels of limitation. With respect to the proposed treaty, these levels are, in general: 10 percent in the case of dividends paid to a 25-percent-or-more corporate owner after 1996 and before 2000, and 15 percent in other cases. The 10-percent rate may be reduced, on a bilateral basis, to conform to the rate that applies to dividends paid after 1999 by Portuguese companies to residents of other European Union member countries (but not less than 5 percent). These limitations contrast with the 5-percent limit on dividends paid to 10-percent or more corporate owners and the 15-percent limit on other dividends contained in the U.S. model. In addition to the reciprocal rates of dividend taxation, Portugal imposes an additional 5-percent substitute gift and inheritance tax (Imposto sobre Sucessoes e Doacoes por Avena) on dividends paid by certain Portuguese corporations.

(16) Generally, the proposed treaty, the U.S. model, and the OECD model all share a common definition of the term "dividends."[2] The proposed treaty further defines this term, however, to include income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the local law on the country in which the income arises. This clarifies that each country is to apply its domestic law, for example, in differentiating dividends from interest.

Additionally, the proposed treaty, as amended by paragraph 4 of the proposed protocol, prescribes a maximum withholding rate of 15 percent on dividends if those dividends are paid by a regulated investment company (a "RIC"), regardless of whether the RIC dividends are paid to a direct or portfolio investor. The proposed treaty does not permit a reduction of U.S. withholding tax on dividends if those dividends are paid by a real estate investment trust (a "REIT"), unless the dividends are beneficially owned by an individual holding a less than 25-percent interest in the REIT.

(17) The OECD model permits the source country to tax interest at a rate of up to 10 percent. Under the U.S. model, all interest generally is exempt from source country withholding tax. The proposed treaty (Article 11) generally follows the OECD model and allows a 10-percent rate of withholding tax at the source on gross interest. As an exception to this general rule, unlike the model treaties and most other U.S. tax treaties, but like the U.S. treaties with Spain and Canada, interest derived by the governments of the countries and their wholly-owned entities, derived by financial institutions on certain long-term loans, or paid in connection with the sale on credit of industrial, scientific, or commercial equipment is exempt from source country withholding tax. The exemption from withholding tax for government-owned entities is broader than U.S. internal law (Code sec. 892(a)(1)(A)).

In addition, the proposed treaty permits each country to impose a branch-level interest tax on certain amounts of interest expense deducted by a permanent establishment located in that country of a corporation resident in the other country. The rate of branch-level interest tax that may be imposed by a country is limited by

[2] That definition is "income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."

the proposed treaty to 10 percent (5 percent in the case of bank interest). A similar branch-level interest tax rule is found in the U.S.-Spain treaty.

(18) Like most recent U.S. tax treaties, under paragraph 9 of the proposed protocol, no reduction of U.S. withholding tax would be granted under the proposed treaty to a Portuguese resident that is a holder of a residual interest in a U.S. real estate mortgage investment conduit (a "REMIC") with respect to any excess inclusion.

(19) The proposed treaty at Article 12, similar to U.S. treaties negotiated since 1986, expressly permits the United States to impose its branch profits tax, at the same rate as that allowed under the proposed treaty for intercorporate dividends (currently 15 percent or a lower rate after 1997). The United States may also impose its excess interest tax on a Portuguese corporation. The rate of the excess interest tax is 5 percent in the case of Portuguese banks, and 10 percent in all other cases. Under paragraph 10 of the proposed protocol, the same rules and limitations will be applicable to any future branch profits tax to be imposed by Portugal.

(20) The proposed treaty allows source-country taxation of royalties at a 10-percent rate (Article 13). Both the U.S. and OECD models exempt royalties from source-country tax. In addition, the proposed treaty includes in the definition of royalties payments of any kind received in consideration for the use of, or the right to use, industrial, commercial, or scientific equipment. Such payments are not treated as royalties under the U.S. model; rather, they generally are treated as business profits.

(21) Although not found in the OECD model, the U.S. model, or many other U.S. treaties, the proposed treaty contains a special provision for determining the source of royalties (Article 13(5)). This provision only applies for purposes of determining whether royalties are taxable in the source country; it is not applicable in determining the source of royalties for purposes of computing the foreign tax credit under the article on relief from double taxation (Article 25). The special sourcing provision includes four separate rules. First, if the payor of a royalty is the government of one of the treaty countries (or political subdivision or local authority thereof), then the royalty is sourced in that country. Second, if the royalty is paid by a person, whether or not a resident of one of the two countries, who has a permanent establishment or fixed base in one of the countries in connection with which the liability to pay the royalty arose, and if the royalty is actually borne (i.e., is deducted in computing taxable income) by that permanent establishment or fixed base, then the royalty is sourced in the country in which the permanent establishment or fixed base is located. Third, if a royalty is not borne by a permanent establishment or fixed base located in one of the countries, then it is sourced in the country of the payor's residence (as determined under the proposed treaty). Fourth, where the person paying a royalty neither is a resident of, nor has a permanent establishment or fixed base in, one of the countries, but the royalty relates to the use of (or right to use) property in one of the countries, then the royalty is sourced in the country where such property is used. Similar source rules for royalties are contained in the U.S. treaties with Australia, New Zealand, Spain, and Mexico.

By contrast, under the domestic law of the United States, royalties generally are sourced in the country where the property giving rise to the royalty is used (Code sec. 861(a)(4)). The U.S. model, which does not permit source country taxation of royalties, does not alter the source rule of domestic law.

(22) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of property used in the business of a permanent establishment in the source country (Article 14). In addition, like most recent U.S. tax treaties, the proposed treaty specifically provides for source-country taxation of such gains where the payments are received after the permanent establishment has ceased to exist.

Unlike the model treaties and most U.S. treaties, however, under paragraph 12 of the proposed protocol, tax may be imposed by the source country only on the amount of the gain that has accrued at the time of the property's removal from that country. Moreover, the proposed treaty provides that gain may be taxed in the other country, in accordance with its law, but only to the extent of the gain accruing subsequent to the time of removal from the first country.

The Committee understands that this provision represents a compromise between the Portuguese custom of taxing accrued, but unrealized gains at the time the asset is removed from Portugal, with the U.S. rules under Code section 864(c)(7), which generally permit the United States to tax the realization of gains from the disposition of property that formerly was part of a U.S. business. This rule of the proposed treaty is not subject to the saving clause.[3]

The Technical Explanation states that this provision will not affect the operation of U.S. law (Code sec. 987) regarding foreign currency gain or loss on remittances of property or currency by a qualified business unit. The Technical Explanation also indicates that taxpayers will not receive a new basis in remitted property for all purposes, but rather will be required to keep records establishing the value of remitted property at the time of remittance. The United States will then tax only additional increments in value in the event of a sale of the property following a remittance.

Paragraph 12 of the proposed protocol also provides that if a U.S. company incorporates its permanent establishment in Portugal, the company may defer the Portuguese tax otherwise imposed on the appreciation of the assets of the permanent establishment, and instead, carry over the basis of the assets from the permanent establishment to the subsidiary. This provision is required by the European Union with respect to its member countries.

(23) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of

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[3] The exception from the saving clause for this rule was omitted from the proposed protocol as signed (and as submitted to the Senate) (paragraph 1(c)). By exchange of diplomatic notes on the 7th of October, 1994, the United States and Portugal added the exception for this rule. As corrected, paragraph 1(c) of the proposed protocol provides as follows (with the additional clause emphasized):

The provisions of the preceding subparagraph (b) shall not affect:

(a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), *under paragraph 3 of Article 14 (Capital Gains)*, under paragraphs 1(b) and 4 of Article 20 (Pensions, Annuities, Alimony and Child Support), and under Articles 25 (Relief from Double Taxation), 26 (Non-Discrimination), and 27 (Mutual Agreement Procedure); and

(b) the benefits conferred by a Contracting State under Articles 21 (Government Service), 22 (Teachers and Researchers), 23 (Students and Trainees), and 29 (Diplomatic and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

real property, including U.S. real property interests, regardless of whether the taxpayer is engaged in a trade or business in the source country. The proposed treaty expands the U.S. model treaty definition of real property for these purposes to encompass U.S. real property interests. This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980, which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations.

(24) The proposed treaty (Article 14) exempts all other gains from source-country taxation. This includes gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining thereto (such as containers). The proposed treaty exempts from source-country taxation gain from the alienation of containers operated in international traffic where such gain is not attributable to a permanent establishment.

(25) In a manner similar to the U.S. model treaty, the proposed treaty (Article 15) provides that income derived by a resident of one of the treaty countries from the performance of professional or other personal services in an independent capacity generally will not be taxable in the other treaty country unless the services are or were performed in that other country and the person either (a) has or had a fixed base there regularly available for the performance of his or her activities, or (b) is or was present there for more than 183 days in any 12-month period. In such a case, the other country will be permitted to tax the income from services performed in that country as are attributable to the fixed base.

(26) The dependent personal services article of the proposed treaty (Article 16) varies slightly from that article of the U.S. model. Under the U.S. model, salaries, wages, and other similar remuneration derived by a resident of one treaty country in respect of employment exercised in the other country is taxable only in the residence country (i.e., is not taxable in the other country) if the recipient is present in the other country for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned and certain other conditions are satisfied. The proposed treaty contains a similar rule, but provides that the measurement period for the 183-day test is not limited to the taxable year; rather, the source country may not tax the income if the individual is not present there for a period or periods exceeding in the aggregate 183 days in a 12-month period. This modification is found in many newer U.S. treaties.

(27) The proposed treaty allows director's fees derived by a resident of one treaty country for services performed in the other country in his or her capacity as a member of the board of directors or supervisory board (or another similar organ) of a company which is a resident of the other country to be taxed in that other country (Article 18). The U.S. model treaty, on the other hand, generally treats directors' fees under other applicable articles, such as those on personal service income. Under the U.S. model (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty the country where the company is resident has full taxing jurisdiction over directors' fees and other similar

payments the company makes to residents of the other treaty country, regardless of where the services are performed. Thus, the proposed treaty represents a compromise between the U.S. model and the OECD model positions.

(28) The limitation on benefits articles in the U.S. model and in the proposed treaty (Article 17) have certain dissimilarities. The U.S. model generally provides entitlement to treaty benefits only to entities that (a) are more than 75 percent beneficially owned by individual residents of the country of residence of the entity,[4] and (b) do not use a substantial portion of their income to meet liabilities of persons who are neither residents of either treaty country nor U.S. citizens (a "base erosion" rule).

In addition, the U.S. model contains two special rules. First, the ownership and base-erosion rules discussed above do not apply if it is determined that the principal purpose behind the acquisition or maintenance of an entity and the conduct of its operations was not to obtain treaty benefits. Second, the U.S. model specifies that no treaty relief is granted by one country to a resident of the other country to the extent that, under the domestic law of that other country, the income to which the relief relates bears significantly lower tax than similar income arising in the other country derived by its residents. The proposed treaty incorporates aspects of the principles of both of these rules. For example, the proposed treaty denies treaty benefits to persons entitled to the tax benefits relating to the tax-free zones of Madeira and Santa Maria Island, or to other similar measures adopted by either country after September 6, 1994.

The proposed treaty enumerates categories of persons that are entitled to treaty benefits. The persons listed in the proposed treaty to whom treaty benefits are extended include (a) individual residents of either treaty country, (b) the government of either country (including political subdivisions or local authorities thereof, and wholly owned institutions and organizations), (c) certain publicly traded companies, (d) certain not-for-profit organizations provided that more than half of the beneficiaries, members, or participants in such organizations are entitled to treaty benefits under this article, and (e) companies that are more than 50-percent beneficially owned, directly or indirectly, by persons entitled to treaty benefits or by U.S. citizens, and that meet a base-erosion test similar to the one included in the U.S. model.

Furthermore, treaty benefits are available with respect to an item of income derived in the other country that is connected with or incidental to the active conduct by a person of a trade or business in the country of residence (other than making or managing investments except for banking and investment activities carried on by a bank or insurance company) and the trade or business is substantial in relation to the activity in the other country that generated the income.

A person not specifically mentioned in this article may not obtain benefits under the treaty unless that person is able to demonstrate to the competent authority of the country in which income arises

[4] A company whose stock is substantially traded on a recognized exchange in one of the treaty countries is presumed owned by individual residents of that country.

that the granting of treaty benefits is warranted in that person's particular case.

(29) Under Article 19 of the proposed treaty, a source country may tax income derived by artistes and sportsmen from their activities as such, without regard to the existence of a fixed base or other contacts with the source country, if that income exceeds $10,000 in a taxable year. Under the U.S. model treaty, entertainers and athletes are so taxable in the source country only if they earn more than $20,000 there during a taxable year. U.S. income tax treaties generally follow the U.S. model rule, but use a lower annual income threshold. Under the OECD model, entertainers and athletes may be taxed only by the country of source, regardless of the amount of income that they earn from artistic or athletic endeavors.

The proposed treaty also includes an exception from source-country taxation of entertainers and athletes resident in the other country if the visit to the source country is substantially supported by public funds of the country of residence. Neither the U.S. model nor the OECD model contains such an exception, although it is found in some recent U.S. treaties.

(30) Under the U.S. model, the United States maintains exclusive rights to tax U.S. social security payments made to residents of the other country or to U.S. citizens. Article 20 of the proposed treaty, by contrast, permits both the United States and Portugal to tax social security and other public pension payments. In cases where both countries tax such payments, the recipient's country of residence is required under the proposed treaty to allow relief from double taxation for any taxes imposed by the other country.

The proposed treaty, like the U.S. model, provides for taxation of annuities and alimony only by the residence country, and taxation of child support payments only by the source country.

(31) The proposed treaty modifies the U.S. model rule that compensation paid by a treaty country government to its citizens for services rendered to that government in the discharge of governmental functions may only be taxed by the government's country. Article 21 of the proposed treaty applies its corresponding rule to all compensation paid by a governmental entity for services rendered to that government entity, regardless of whether the services are rendered in the discharge of governmental functions, so long as the services are not rendered in connection with a business carried on by that governmental entity. Moreover, unlike the U.S. model treaty, the proposed treaty specifies that compensation by a governmental entity is taxable only by the other country if the services are rendered in that other country, and the individual is a resident and citizen of that other country and not also a citizen of the paying country. This rule is similar to the corresponding rule in the OECD model treaty. A similar rule applies to governmental pensions.

(32) Unlike the model treaties, but similar to a number of existing U.S. treaties with other countries (see, e.g., the U.S.-Indonesia, U.S.-Czech Republic and the U.S.-Slovak Republic treaties), the proposed treaty generally exempts from source country tax for two years income of a resident of one country relating to teaching or research activities if the resident's sole purpose to visit the country

is to teach or conduct research at an educational institution. The benefits of this article only apply under the proposed treaty to income received for carrying out research for public benefit. In addition, an individual is entitled to the benefits of this provision only once. No individual may be entitled to both the benefits of this article (Article 22) and the benefits of Article 23 (on students and trainees).

(33) The U.S. model, the OECD model, and the proposed treaty provide a general exemption from host-country taxation of certain payments from abroad received by students and trainees who are or were resident of one country and present in the host country. Whereas the U.S. and OECD models permit this exemption without regard to any income threshold or time limit, the proposed treaty allows it only for a period not exceeding five years with respect to students, and only for a period of 12 consecutive months with respect to trainees.

The proposed treaty extends the same exemption to researchers on certain grant receipts from wherever they may arise. In addition, the proposed treaty limits the exemption for trainees to an aggregate amount of income not in excess of $8,000. The proposed treaty also permits an exemption from host-country tax for up to $5,000 each tax year of personal services income earned by certain visiting students and others. Neither the U.S. model nor the OECD model contains such an exemption.

(34) The proposed treaty contains an "other income" article which differs fundamentally from the "other income" article of the U.S. model treaty. Under the U.S. model, income not dealt with in another treaty article generally may be taxed only by the residence country. By contrast, Article 24 of the proposed treaty, like, for example, the U.S.-Mexico treaty, specifies that items of income of a resident of a treaty country which are not dealt with elsewhere in the treaty and which arise in the other treaty country may also be taxed in the other country.

(35) The relief from double taxation article of the proposed treaty (Article 25) is similar to the corresponding articles of the models and recent U.S. treaties. It relieves double taxation by means of a foreign tax credit allowed by the United States, a combination of a credit and an exemption allowed by Portugal and rules of application generally specifying that the country obligated to offer the credit or exemption is the country other than the one to which the proposed treaty accords the primary right to tax the applicable category of income.

The U.S. model provides certain specific sourcing rules for purposes of computing the foreign tax credit. For example, under the U.S. model, income derived by a resident of one country which is taxable in the other country pursuant to the treaty (other than solely by reason of citizenship) is sourced in that other country. Moreover, income derived by a resident of one of the countries which is not taxable by the other country is sourced in the taxpayer's country of residence.

The proposed treaty only provides one foreign tax credit source rule, which has limited application. Under that rule, in the case of a U.S. citizen who is a resident of Portugal whose income is taxable by the United States by reason of that person's citizenship (i.e., in-

come that is taxed by the United States under the saving clause), such income is deemed to arise in Portugal to the extent necessary to avoid double taxation. In all other cases, the source rules of applicable domestic law shall apply.

The OECD model treaty provides for two mechanisms to mitigate double taxation of income: the allowance of foreign tax credit and the exemption of foreign source income. Under the credit approach, the resident country generally allows a deduction against its own tax the amount of tax paid to the source country on a specific item of income. Under the exemption approach, all or a portion of the income from the source country is not subject to the resident country's tax. The U.S. model treaty, in accordance with the internal rules (Code sec. 901–908), only allows a foreign tax credit relief.

Under the proposed treaty, a Portuguese resident may be entitled to a combination of the credit and exemption mechanisms. Generally, a Portuguese resident may be entitled to a foreign tax credit for income tax directly paid to the United States. In addition, certain Portuguese companies that receive dividends from U.S. companies may exempt 95 percent of the dividend from their tax base. The Technical Explanation indicates that such a combination is designed to alleviate double taxation in the case of Portuguese companies that own stock of a foreign corporation, because Portugal does not have any indirect foreign tax credit mechanism (similar to Code sec. 902).

(36) Under the proposed treaty's mutual agreement procedure rules (Article 27), a case must be presented for consideration to a competent authority within five years from the first notification of the action resulting in taxation not in accordance with the provisions of the proposed treaty. The U.S. model does not specify any time limit for presentation of a case to a competent authority, whereas the OECD model provides a three-year time limit for this purpose. In other respects, the mutual agreement procedure rules of the proposed treaty are similar to those in the U.S. model.

(37) The proposed protocol (paragraph 1), provides that the dispute resolution procedures under the mutual agreement article of the proposed treaty takes precedence over the corresponding provisions of any other agreement between the United States and Portugal in determining whether a law or other measure is within the scope of the proposed treaty. Unless the competent authorities agree that the law or other measure is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the nondiscrimination rules of any agreement in effect between the United States and Portugal, generally will apply to that law or measure. The only exception to this general rule is that the nondiscrimination rules of the General Agreement on Tariffs and Trade will continue to apply with respect to trade in goods.

(38) The proposed treaty's exchange of information provision (Article 28) is similar to the corresponding provision in the U.S. model. The proposed treaty provides for the exchange of information relating to taxes of every kind imposed at the national level by the two countries. The proposed treaty, as modified by paragraph 14 of the proposed protocol, also states that information that may be exchanged includes information from records of financial institutions, including bank records of third parties that engage in transactions

with the taxpayer and bank records relating to parties that are entitled to tax benefits of the tax-free zones of Madeira and Santa Maria Island.

(39) The U.S. model provides certain rules regarding tax collection assistance to be provided to one treaty country by the other treaty country. Specifically, the U.S. model provision states that each treaty country shall endeavor to collect on behalf of the other treaty country such amounts as may be necessary to ensure that treaty-relief granted from taxation generally imposed by that other country does not inure to the benefit of persons not entitled thereto. Neither the proposed treaty nor the OECD model contain similar clauses.

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty generally will take effect on January 1 of the year following ratification. The proposed treaty provisions with respect to the rates of taxes collected by withholding generally applies to amounts paid on or after the first day of the next January following the date on which the treaty enters into force. With respect to taxes other than withholding taxes, the proposed treaty will take effect for taxable years beginning on or after the first day of January following the date on which the treaty enters into force.

B. TERMINATION

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it at any time after five years from the date of its entry into force, by giving at least six months prior written notice through diplomatic channels. With respect to taxes withheld at source, a termination will be effective for amounts paid or credited on or after the first of January following the expiration of the six-month period. With respect to other taxes, a termination is to be effective for taxable years beginning on or after the first of January following the expiration of the six-month period.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed treaty and protocol with Portugal, and on other proposed treaties and protocols, on June 13, 1995. The hearing was chaired by Senator Thompson. The Committee considered the proposed treaty and protocol with Portugal on July 11, 1995, and ordered the proposed treaty and protocol favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to the ratification of the proposed treaty and protocol subject to the understandings and with the declarations described below.

VI. Committee Comments

The Committee on Foreign Relations approved the proposed treaty subject to two understandings and with two declarations regarding the provisions of the proposed treaty and protocol. The first understanding affects U.S. taxation of interest payments to certain

Portuguese banks. The second understanding and the first declaration pertain to the Portuguese taxation of dividends paid to U.S. investors. The second declaration relates to the effect of the Portuguese substitute gift and inheritance tax applicable to dividends paid by Portuguese entities. On balance, the Committee believes that the proposed treaty and protocol are in the interest of the United States and urges that the Senate act promptly to give its advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed treaty, and believes that the following comments may be useful to U.S. Treasury officials in providing guidance on these matters.

A. DEVELOPING COUNTRY CONCESSIONS

The proposed treaty contains a number of developing country concessions, most of which are found in some other U.S. income tax treaties, including treaties with developing countries. The most significant of these concessions are described below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for broader source-basis taxation. The proposed treaty's permanent establishment article, for example, permits the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, a building site or construction or installation, or assembly project (or supervisory activities related to such projects) creates a permanent establishment if it exists in a country for more than six months; under the U.S. model, a building site, etc., must last for at least one year. Thus, for example, under the proposed treaty, a U.S. enterprise's business profits that are attributable to a construction project in Portugal is taxable by Portugal if the project lasts for more than six months. Similarly, under the proposed treaty, the use of a drilling rig or ship for the exploration or development of natural resources in a country for more than six months creates a permanent establishment there; under the U.S. model, drilling rigs or ships must be present in a country for at least one year. It should be noted that many tax treaties between the United States and developing countries (including the U.S.-Mexico treaty) provide a permanent establishment threshold of six months for building sites and drilling rigs.

In addition, the proposed treaty and protocol contain a provision, not present in either the U.S. or OECD model treaties, but which has been included in some recent U.S. tax treaties with developing countries (e.g., U.S. treaties with the Czech Republic and Slovakia), which provides that the mere presence of employees of an enterprise in a treaty country for a specified period gives rise to a permanent establishment in that country. The provision treats an enterprise from one country as having a permanent establishment in the other country if it carries on business of a permanent nature in the other contracting state, through its own employees or any other personnel, for a period or periods that equal or exceed in the aggregate 9 months in any 12 month period commencing or ending in the relevant taxable year. The application of this rule is limited

to the first 5 years that the treaty is in effect. Under this rule, for example, a U.S. enterprise is considered to have a permanent establishment in Portugal if its employees are present in the country for 9 months during a calendar year despite the fact that such enterprise does not have an office or other fixed place of business in Portugal. Although this rule provides for source basis taxation that is broader than the rules contained in the U.S. model, it is less broad in some respects than the domestic U.S. rules which provide that an enterprise may be deemed to be engaged in a U.S. trade or business even if the enterprise did not have a presence in the United States for any specified length of time.

Source basis taxation

Additional concessions to source basis taxation in the proposed treaty include maximum source country tax rates on interest (10 percent) and direct dividends (10 percent) that are higher than that provided in the U.S. model treaty; a maximum rate of source country tax on royalties (10 percent) that is higher than that provided in the U.S. model treaty; taxing jurisdiction on the part of the source country as well as the residence country with respect to income not otherwise specifically dealt with by the proposed treaty; and broader source country taxation of personal services income (especially independent personal services income and directors' fees) and income of artistes and sportsmen than that allowed by the U.S. model.

Certain equipment leasing

In addition to containing the traditional definition of royalties which is found in most U.S. tax treaties (including the U.S. model), the proposed treaty provides that royalties include payments for the use of, or the right to use, industrial, commercial, or scientific equipment.[5] These payments are often considered rentals in other treaties, subject to business profits rules which generally permit the source country to tax such profits only if they are attributable to a permanent establishment located in that country, and in such case, the tax is computed on a net basis. By contrast, the proposed treaty permits gross-basis source country taxation of these payments, at a rate not to exceed 10 percent, if the payments are not attributable to a permanent establishment situated in that country.[6]

Issues raised by the Committee

The issue that is of concern to the Committee is whether developing country concessions represent appropriate U.S. treaty policy, and if so, whether Portugal, a member of the European Union ("EU"), is an appropriate recipient of these concessions. During the June 13th hearing Senator Sarbanes requested a description of the developing country concessions in the Portuguese treaty and proto-

[5] Although payments for container leasing are generally treated as royalties under the proposed treaty, they are exempt from source country taxation under paragraph 11 of the proposed protocol.

[6] If the payments are attributable to such a permanent establishment, then the business profits article of the proposed treaty would apply.

col. Treasury Department's response to this inquiry, in a letter dated July 5, 1995,[7] is reproduced below:

> *Developing country concessions*
>
> Senator Sarbanes also asked for a description of developing country concessions in the Portuguese treaty. The principal provisions of this type are a 6 month rule on construction sites and drilling rigs, a 10 percent rate of withholding tax on direct investment dividends and royalties, and treatment of rental income as royalties subject to withholding tax at source.
>
> The 6 month rule on construction sites and drilling rigs is also found in our treaty with Spain. It should be noted that similar provisions are agreed to in treaties with both developed and less-developed economies. Other U.S. income tax treaties with a 6 month (or shorter) rule for construction sites include: Barbados, China, Cyprus, Egypt, Greece, India, Indonesia, Israel, Jamaica, Korea, Malta, Mexico, Morocco, Pakistan, Philippines, Switzerland, Trinidad and Tobago, and Tunisia.
>
> The 10 percent rates on direct investment dividends and royalties are also found in the U.S. income tax treaty with Spain. Unlike Spain, however, Portugal has agreed in advance to reduce the dividend rate to 5 percent in accordance with an anticipated schedule and known triggering event. In the case of Spain, we would have to negotiate a protocol to obtain such a rate, which in all likelihood could be obtained, if at all, only after substantial concessions by the United States. It will not be necessary for the United States to make any concessions in order to obtain this beneficial rate in the case of Portugal.
>
> The definition of royalties to include rentals is also found in other U.S. income tax treaties, including Spain (at a 7 percent rate) and Mexico (at 10 percent rate).
>
> A tax-sparing credit is another very significant developing country concession that is reflected in many Portuguese tax treaties. Many developed nations agree to provide such credits in their tax treaties. The United States, however, declined to include a tax-sparing credit in this treaty.

As discussed below, the proposed treaty and protocol include certain unusual provisions (e.g., nonreciprocal rate of withholding tax on certain dividends and interest payments) that are not typically found in U.S. tax treaties. These provisions, in the aggregate, amount to significant concessions by the United States. Therefore, the Committee queried whether there is substantial reason to deny the ratification of the proposed treaty and protocol. The relevant portion of Treasury's response to this inquiry, in the July 5, 1995 Treasury letter, is reproduced below:

> 2. The treaty also contains many developing country concessions. In light of the numerous concessions in this trea-

[7] Letter from Assistant Secretary of the Treasury (Tax Policy), Leslie B. Samuels to Senator Fred Thompson, Committee on Foreign Relations, July 5, 1995 ("July 5, 1995 Treasury letter").

ty, isn't there substantial reason for this Committee to deny its recommendation of advice and consent to ratification?

Failure to recommend advice and consent to ratification would result in the denial of very substantial benefits to the many U.S. companies investing in Portugal. While the treaty contains several provisions that are common in treaties with developing countries, these provisions reduce significantly Portugal's tax barriers to U.S. investment.

These provisions result from the fact that relatively one-sided investment flows and lack of economic development in one of the countries result in a different balance of interests than in negotiations between two equally developed countries. However, these provisions are not more generous to Portugal than those in other recent U.S. treaties with developing countries, such as Mexico and Spain. They are fully consistent with Portugal's status as an EU member that is underdeveloped in comparison to most EU members.

Portugal has a relatively low per capita gross domestic product, and little investment abroad. It is not surprising that it seeks to preserve its tax at source. The European Union itself has made special concessions to Portugal, for example delaying the date by which they must implement the exemption of sub-parent dividends paid to other EU countries.

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Portugal. The practical effect of these developing country concessions could be greater Portuguese taxation of future activities of U.S. firms in Portugal than would be the case under the rules of either the U.S. or OECD model treaties.

Conclusion of the committee

The Committee is concerned that the developing country concessions contained in the proposed treaty not be viewed as the starting point for future negotiations with developing countries. It must be clearly recognized that several of the rules of the proposed treaty represent substantial concessions by the United States, and that such concessions must be reciprocated by the treaty partner. Thus, future negotiations with developing countries should not assume, for example, that the definition of a permanent establishment provided in this treaty will necessarily be available in every case; rather, such a definition will only be adopted in the context of an agreement that satisfactorily addresses the concerns of the United States.

B. SUBSTITUTE GIFT AND INHERITANCE TAX

The proposed treaty and protocol allow Portugal to impose a higher rate of tax on dividends (and potentially interest) paid by certain Portuguese payers to U.S. recipients than the rate that the United States may impose on similar payments from U.S. payers to Portuguese recipients.

General rule

The domestic Portuguese income tax withholding rate on dividends is 25 percent. The rate is reduced to either 10 percent (note that this rate may be reduced to 5 percent in the future, see discussion below regarding "Modification of Withholding Rate for Dividend") or 15 percent under Article 10 of the proposed treaty. In addition to this tax, Portugal also imposes a 5-percent substitute gift and inheritance tax (Imposto sobre Sucessoes e Doacoes por Avenca) on dividends paid by certain Portuguese corporations (Sociedades Anonimas, or SAs).[8] The ability of the Portuguese tax authorities to impose the substitute gift and inheritance tax is generally unrestricted by the proposed treaty.[9] Because the United States does not have any similar levies on dividends paid by U.S. companies, there are nonreciprocal treaty rates for dividends under the proposed treaty (*i.e.,* a maximum rate of 20 percent for dividends paid by a Portuguese corporation but a maximum rate of 15 percent for dividends paid by a U.S. corporation).

Even though the percentage of U.S.-owned Portuguese corporations that are SAs is relatively low, estimated to be less than 10 percent,[10] more than 30 percent of U.S. investment in Portuguese companies is made though SAs.[11] Thus, it is likely that a substantial amount of repatriations made to U.S. shareholders of Portuguese companies are subject to this 5-percent additional tax.

The Portuguese substitute gift and inheritance tax may also apply to interest from certain bonds. Interest on government and corporate bonds issued through 1995 is currently exempt from the tax. Despite the dormant status of this tax on interest, there is no guarantee that an exemption from the tax will continue indefinitely. Furthermore, the proposed treaty does not limit the substitute gift and inheritance tax rate on interest if the exemption expires or is lifted. Thus, Portugal has the ability to unilaterally increase the amount of withholding tax on interest paid to U.S. recipients to an unknown rate beyond what is negotiated under the proposed treaty, causing uncertainty for U.S. investors of interest-bearing Portuguese obligations. Even if the rate remains constant, a U.S. recipient of the interest would be subject to 5-percent additional tax above the 10-percent rate allowed under the proposed treaty if the current exemption is no longer available. Meanwhile, a Portuguese recipient of non-exempt U.S. interest would continue to enjoy the 10-percent U.S. withholding rate set forth by the proposed treaty.

A broader issue is whether it is appropriate for a bilateral U.S. tax treaty to allow the treaty partner to impose a non-reciprocal

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[8] It is the understanding of the Treasury Department that the substitute gift and inheritance tax would not be applied to amounts of interest, royalties, or other payments or prices between related parties that exceed an arm's-length amount, whether or not such excess amounts are characterized as dividends paid by SAs.

[9] However, paragraph 8 of the proposed protocol provides that any future increases in the tax rate will not be applicable to dividends beneficially owned by U.S. residents.

[10] During 1990, the most recent year that information is available, there were 19 SAs owned by certain U.S. parents (*i.e.,* those that have more than $500 million in assets) and there were approximately 200 U.S.-owned active Portuguese corporations in the same category. "Foreign Corporation Information Study, 1990 Tax Form 5471," Statistics of Income Division, Internal Revenue Service February, 1990.

[11] The amount of assets held by these U.S.-owned Portuguese SAs exceeded $1 billion in 1990 while the aggregate amount of assets held by all such U.S.-owned Portuguese companies were approximately $3.2 billion. *Id.*

tax on the income paid to a U.S. recipient. Despite the label of "substitute gift and inheritance" tax, the levy is imposed on an income stream of the recipient. Consequently, the tax, in substance, functions as an income tax on the amount of dividends (and potentially interest) payable to U.S. recipients of certain income from Portuguese sources. In fact, the Technical Explanation indicates that Portugal's characterization of the tax does not affect the determination of whether it qualifies as an income tax according to the standards established by Code Sec. 901 and the regulations thereunder.[12] There is an apparent conflict between Treasury Department's belief that the tax may be an income tax for U.S. tax purposes and its willingness to accept the Portuguese government's position that the tax is not an income tax for Portuguese tax purposes and, therefore, not a covered tax under the proposed treaty.

As part of its consideration of the proposed treaty, the Committee questioned the rationale behind allowing Portugal to impose the additional 5-percent gift and inheritance tax on U.S. investors. The relevant portion of Treasury's response to these inquiries in the July 5, 1995 Treasury letter is reproduced below:

> 3. Why does the Treaty permit Portugal to impose an additional 5 percent on dividends to U.S. investor?
>
> Portugal considers its 5 percent tax on certain dividend distributions by Portuguese companies to be a substitute for the inheritance tax on corporate shares. It has not covered this tax in any of its tax treaties. Further, it has not capped this tax in any of its tax treaties other than the proposed treaty with the United States. Accepting this tax is not our preferred position, but was judged necessary to obtain the many other treaty benefits.

The Committee has included a declaration expressing its concern for the nonreciprocal nature of the Portuguese Substitute Gift and Inheritance Tax. The acceptance of this provision reflects a substantial concession by the United States and should not be viewed as a precedent for future U.S. tax treaties, particularly treaties with developing nations. The declaration serves to inform the Treasury that the inclusion of a similar provision in any future treaties could serve as a bar for Senate advice and consent to the ratification of such treaties. The declaration also states that the Portuguese Government should take appropriate steps to insure that interest and dividend income beneficially owned by residents of the United States is not subject to higher effective rates of taxation by Portugal than the corresponding rates of taxation imposed by the United States on such income beneficially owned by residents of Portugal. It is further declared that the United States should communicate this sense of the Senate to the Portuguese Republic.

Creditability of the substitute gift and inheritance tax

The Code seeks to mitigate double taxation generally by allowing U.S. taxpayers to credit the foreign income taxes that they pay against U.S. taxes imposed on their foreign source income. By al-

[12] See the discussion in the following section regarding the creditability of the Portuguese substitute gift and inheritance tax against U.S. income tax.

lowing a foreign tax credit, however, the United States (the residence country) effectively cedes primary taxing jurisdiction to the foreign country that imposes the creditable tax (the source country) inasmuch as the amount of the credit reduces the U.S. tax liability of the taxpayer claiming the credit.

The Technical Explanation indicates that the characterization of the tax by Portugal as a substitute gift and inheritance tax will not affect the determination as to whether it is an income tax creditable for U.S. tax purposes. The effect of allowing a U.S. foreign tax credit for the Portuguese substitute gift and inheritance tax would be for the United States to forgo its revenue to the extent of such credit, resulting in concession by the United States. If the United States were to deny U.S. taxpayers a foreign tax credit for the substitute gift and inheritance tax under its domestic law, the burden of the additional 5 percent tax would be shifted from the United States to affected U.S. taxpayers, resulting in double taxation to such taxpayer. This may be illustrated by the following example:

> *Example.*—Assume that a U.S. corporation owns 5 percent of the stock of a Portuguese SA which pays a dividend of $100 after the treaty has entered into force. Portugal would withhold $20 of taxes from the distribution ($15 of regular tax plus $5 of substitute gift and inheritance tax). If the full amount of Portuguese withholding tax is creditable against the U.S. recipient's federal tax liability of $35 ($100 taxed at 35 percent), then the residual U.S. tax on the dividend would be $15. On the other hand, if only $15 of the withholding tax is creditable, and $5 is eligible only for a deduction, then the residual U.S. income tax on the dividend would be $18.25 ($33.25 less $15). In such case, the U.S. taxpayer would be subject to double taxation to the extent of the difference between a credit and a deduction for the $5 substitute gift and inheritance tax ($3.25).

The effect of permitting the creditability of the tax, as illustrated above, generally may be to erode the U.S. tax base.[13]

The proposed treaty and Technical Explanation do not specifically address whether the substitute gift and inheritance tax is a creditable tax for U.S. tax purposes. In the past, the tax-writing committees have made clear their view that treaties are not an appropriate vehicle for granting unilateral tax credits. This Committee generally agrees with that view, and wishes to emphasize that foreign tax credit issues, including whether a foreign levy is a creditable tax, generally should be dealt with under the domestic law of each country.

C. MODIFICATION OF WITHHOLDING RATE FOR DIVIDENDS

Under the proposed treaty, dividends paid by a company that is a resident of one country to a resident of the other country are taxable by both countries. The proposed treaty limits, however, the rate of tax that the country of which the payor is a resident may impose on dividends paid to a beneficial owner in the other coun-

[13] In the case of taxpayers with excess foreign tax credits a deduction for a noncreditable substitute gift and inheritance tax may be more advantageous than an additional foreign tax credit for the same amount.

try. The rate of source-country tax generally cannot exceed 15 percent of the gross amount of the dividend. The maximum rate of source-country tax is 10 percent with respect to dividends paid after 1996, if the beneficial owner is a company which directly owns at least 25 percent of the capital of the company paying the dividends for an uninterrupted period of 2 years prior to the year the dividend is paid (the "intercorporate dividend rate"). With respect to dividends paid after 1999, the intercorporate dividend rate under the proposed treaty would be the same as the rate that Portugal may apply to dividends paid to residents of EU member countries, but not below 5 percent. The Committee understands that Portugal has a temporary derogation from the requirement that no withholding tax be imposed on intercorporate dividends within the EU, allowing it to impose 10-percent withholding tax on such dividends. Unless this derogation is extended beyond 1999, Portugal will not be permitted to impose any withholding tax on intercorporate dividends within the EU.

U.S. tax treaties typically establish a self-contained schedule of tax rates to be applied between the treaty countries, with or without phase-in or other transition rules. In contrast, the proposed treaty leaves the post-1999 withholding rates on direct dividends to be determined in accordance with the status of Portugal's EU derogation. The proposed treaty has the effect of establishing the withholding rates on certain dividends between the United States and Portugal in negotiations between Portugal and the governing bodies of the EU.

As part of the Committee's consideration of the proposed treaty, the Committee requested the Treasury Department to provide additional information regarding this issue. The relevant portion of Treasury's response to this inquiry, in this July 5, 1995 Treasury letter, is reproduced below:

> 4. Why does the treaty contain a self-executing MFN provision to lower the direct dividend rate to 5 percent?
>
> This provision is not an MFN provision. An MFN provision is a provision that requires one of the parties to grant the same benefit that it may grant in the future to an unspecified treaty partner. Unlike the typical MFN provision, the provision in the Portuguese treaty does not require Portugal to grant the same benefit to the United States that it will grant to another party. It simply provides that the dividend rate will be reduced from 10 to 5 percent (not the E.U. rate of 0) when Portugal's integration into the E.U. is complete. Unlike an MFN provision, the Senate knows what the extent of the reduction in the withholding rate will be, when this reduction is scheduled to occur, and what the triggering event will be.
>
> This provision differs from the dividend provision in the recent treaty with Mexico in that it is a concession made *to*, not *by*, the United States. It cannot be triggered by a provision in any future U.S. treaty and has no effect on U.S. treaties with other countries.
>
> This provision is best viewed as a simple transition rule that allows the United States to obtain its preferred direct dividend rate of 5 percent on a delayed basis. Without this

provision, U.S. companies would have to pay 10 percent on direct investment dividends from Portugal when companies in other E.U. countries would be exempt.

If we wait until the E.U. directive takes effect for Portugal in 2000 and propose a protocol, we have no way to assure that we will obtain the 5 percent rate, and in any event would have to offer U.S. concessions in exchange. Therefore, the United States and U.S. companies are in a substantially better position with this provision than with a provision that would require further negotiations and approval by both governments. The provision therefore is clearly in the best interest of the United States and should be accepted.

The reduction in withholding tax rate contemplated by this provision is consistent with U.S. tax policy. Notwithstanding the fact that the treaty modification authorized to be effective without further ratification procedures would conform the treatment of certain dividends to the preferred U.S. position, the Committee is concerned about the self-executing nature of this provision. The Committee believes that a subsequent amendment to a previously ratified treaty should be subject to the advice and consent of the Senate. The Committee is concerned that approval of such provision could set an inappropriate precedent, affecting not only tax treaties but all other international agreements and disrupting the delicate balance of power between the legislative and executive branches of government. Hence, the Committee wishes to emphasize that its acceptance of this provision in the context of the proposed treaty is not intended to establish any such precedent. Furthermore, the Committee is troubled by the fact that the timing of this reduction is established without the participation of the United States. Indeed, it is possible (though perhaps unlikely) that the reduction might never occur, a possibility that increases the Committee's concern about granting open-ended developing country concessions.

Therefore, the Committee recommends that the Senate give its advice and consent to the proposed treaty and protocol subject to an understanding and with a declaration with regard to this provision. The understanding and declaration are designed to work together to ensure that the Treasury Department and the Senate are kept informed regarding the efforts of the Portuguese Republic and the EU to reduce the rate of taxation imposed by Portugal on dividends.

D. LIMITED RECIPROCAL EXEMPTION FOR CERTAIN INTEREST

The proposed treaty generally allows the source country to impose a 10-percent tax on interest that arises from that country if the beneficial owner of the interest is a resident of the other country. Certain exceptions apply to the general rule that permits the source country to tax interest income. One of the exceptions exempts interest from source country tax if the interest is beneficially owned by the other country, its political subdivision or local authority, or its wholly-owned institutions or organizations, including financial institutions.

This exemption under the proposed treaty is broader than the one contained under the U.S. domestic rules; it also provides unique benefits to certain Portuguese commercial banks. Code section 892(a) exempts certain non-commercial passive income of a foreign government and certain government-owned entities from U.S. federal income tax. The exemption is not applicable, however, to income derived from commercial activities or by a government controlled commercial entity (Code sec. 892(a)(2)(A)).

It is the understanding of the Committee that Portuguese internal law does not have any provision similar to Code section 892. Absent any such specific treaty exemption, the Technical Explanation states that Portugal would tax interest paid by a Portuguese borrower to U.S. government agencies such as the U.S. Export-Import Bank ("Eximbank") and OPIC. The Treasury Department has advised the Committee that the above-referenced exemption of the proposed protocol is principally intended to avoid source country taxation of interest paid to these agencies.[14] In a recent report, three of the six largest Portuguese commercial banks were government owned, and rank among the 500 largest banks in the world.[15] Because some of these entities may not have a permanent establishment in the United States, the proposed treaty exempts from U.S. tax U.S. source interest paid to these commercial banks that are otherwise subject to U.S. withholding tax.[16] The Treasury Department has advised the Committee, however, that Portugal is undertaking to privatize its government-owned commercial banks and only one commercial bank remains wholly owned by the Portuguese government, and that bank is not chartered to make foreign loans. U.S. commercial banks (none of which is government-owned) receive no similar treaty benefit. If Portugal in the future should change its policy with respect to government ownership of its commercial banks, it may be possible for Portuguese government-owned commercial banks to take advantage of the override of Code section 892(a)(2)(A) by increasing their lending activities to U.S. borrowers from abroad to avoid U.S. tax on the interest. Therefore, the rule may arguably create unfair competition for U.S. commercial banks, as well as non-Portuguese foreign banks, in lending to U.S. borrowers.

In addition, the granting of a blanket exemption from U.S. tax on interest paid to Portuguese commercial banks in return for a similar exemption for interest received by OPIC and the Eximbank are not reciprocal measures. OPIC and the Eximbank are self-sustaining agencies of the U.S. government established to encourage world trade; Portuguese commercial banks are profit-seeking busi-

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[14] There are alternatives to providing a general exemption on interest paid to all government-owned institutions and organizations. For example, the negotiators could have limited the exemption to specific government agencies. See paragraph 4(d) and (e), Article 11 of the U.S.-Mexico treaty which narrows the exemption to interest arising in Mexico received by the Eximbank and OPIC with a reciprocal exemption provided to interest earned by similar Mexican institutions. See also Article 11, paragraph 3(a) of the treaty between the United States and Jamaica for a similar provision.

[15] The banks are ranked by the amount of their assets as of their fiscal year ended 1993. See "The Top 500 Banks in the World," "American Banker," July 29, 1994, at 7A.

[16] Without the special exemption under the proposed treaty, the interest would be subject to U.S. tax at the rate of 30 percent under U.S. law (Code secs. 1441 and 1442) or at 10 percent under the proposed treaty.

ness entities.[17] Exempting interest earned by Portuguese commercial banks, regardless of their ownership, is analogous to having a treaty partner of the United States exempt from its taxation any interest paid to a major U.S. commercial bank, a provision that is very unlikely to be accepted by any of our treaty partners.

As part of its consideration of the proposed treaty, the Committee queried the Treasury Department with respect to the rationale for granting such a concession. The relevant portion of Treasury's response, in the July 5, 1995 Treasury letter, is reproduced below:

> 1. Such an exemption [for interest paid to government-owned banks] is a major concession. Why is this appropriate treaty policy?
>
> The preferred U.S. policy is full exemption at source of interest. When it is not possible to accomplish that objective, it is customary to seek exemption in specific cases, including the case of interest paid to government financial institutions that finance trade and investment, such as Eximbank and OPIC. This provision will not operate unfairly in this treaty. The exemption applies only to banks wholly owned by the government. All such Portuguese banks have been privatized, with the exception of one bank that does not engage in international lending. Portugal has very little investment in this country. Therefore this provision represents—at most—a minor concession.
>
> It is our understanding that major U.S. banks have expressed strong support for this treaty and the other treaties before the Committee. They, therefore, do not appear to view this provision as operating to their disadvantage. Eximbank and OPIC also correctly see it as operating in their interest.

The Committee has included an understanding to ensure that this provision will not exempt from U.S. tax U.S.-source interest paid to any Portuguese commercial banks, even if they are government owned. The trend to privatize Portuguese commercial banks is consistent with this position. The understanding also is intended to cause the United States and Portugal to renegotiate and restore the balance of benefits in the event Portugal changes its internal policy so that U.S. source interest earned by Portuguese government-owned commercial banks would be exempt from U.S. tax. Furthermore, the Committee reiterates its belief that broadly-written provisions exempting interest derived through commercial activities of government-owned entities do not reflect appropriate U.S. tax treaty policy and should not be a precedent for future treaty negotiations.

E. TREATY SHOPPING

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to

[17] Portuguese commercial banks have as their exclusive purpose the exercise of banking activities for profits. See Banco Portuguese do Atlantico, division of studies, marketing and planning, "The Portuguese Financial System, a Brief Outlook," at 20 (1988).

benefit residents of Portugal and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as "treaty shopping". Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country, which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision of the proposed treaty is similar to an anti-treaty-shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties. Some aspects of the provisions, however, differ either from the corresponding provision of the U.S. model or from the anti-treaty-shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. An issue, then, is whether the proposed anti-treaty-shopping provisions effectively forestall potential treaty-shopping abuses.

One provision of the anti-treaty-shopping article of the proposed treaty is more lenient than the comparable rule in the U.S. model and other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the company's country of residence, while the proposed treaty (like several newer treaties and an anti-treaty-shopping provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country, citizens of the United States, and certain other specified persons. Thus, this safe harbor is considerably easier to enter under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed; that is, ownership by third-country residents attempting to obtain treaty benefits. In addition, a base-erosion test contained in the proposed treaty provides protection from certain potential abuses of a Portuguese conduit.

Another item contained in the proposed treaty's anti-treaty-shopping rules differs from the U.S. model. This provision permits an entity, not otherwise authorized to obtain treaty benefits, to obtain benefits under the proposed treaty if it can demonstrate to the competent authority of the country in which the income in question arises that such person is deserving of treaty benefits. The proposed treaty states that in making its determination whether or not to extend treaty benefits, the competent authority of the relevant country shall take into account, among other things, whether the establishment, acquisition, and maintenance of the entity, and the conduct of its operations, did not have as one of its principal purposes the obtaining of benefits under the proposed treaty. A rule of the U.S. model, on the other hand, provides that treaty benefits shall not be limited if it is determined that the acquisition or maintenance of the entity and the conduct of its operations did not

have as a principal purpose the purpose of obtaining treaty benefits. Although both provisions contain a principal purpose test, it appears that the provision of the proposed treaty grants the relevant competent authority greater opportunity to refuse treaty benefits since the principal purpose behind the establishment, acquisition, or maintenance of the entity and the conduct of its operations is just one of the factors to be taken into consideration.

One limitation on benefits provision proposed at the time that the U.S. model treaty was proposed provides that any relief from tax provided by the United States to a resident of the other country under the treaty shall be inapplicable to the extent that, under the law in force in that other country, the income to which the relief relates bears significantly lower tax than similar income arising within that other country derived by residents of that other country. With similar purposes, the benefits of the proposed treaty are denied to any person that is entitled to the tax benefits relating to the tax-free zones of Madeira and Santa Maria Island, or to similar benefits under any legislation or similar measures adopted by either country after the date the proposed treaty is signed. The competent authorities are to notify each other of any such legislation or measure and to consult as to whether such benefits are similar.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department to provide additional explanation regarding the sufficiency of the anti-treaty shopping provisions in the proposed treaty and other treaties. The relevant portion of Treasury's response to this inquiry in the July 5, 1995 Treasury letter is reproduced below:

> 7. Is Treasury confident that the anti-treaty shopping provisions in these treaties will ensure full payment of taxes by multinational corporations and eliminate abuse of the treaties to lower taxes?
>
> In conjunction with various domestic statutes and regulations, the limitation on benefits provisions should be very effective in preventing underpayment of U.S. withholding taxes by non-residents, including multinationals.

The Committee believes, as it has stated in the past, that the United States should maintain its policy of limiting treaty-shopping opportunities whenever possible, and in exercising any latitude Treasury has to adjust the operation of the proposed treaty, the Committee is particularly concerned that the rules as applied would adequately deter treaty-shopping abuses. The proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Portugal because third-country investors may be unwilling to share ownership of such investing entities on a 50–50 basis with U.S. or Portuguese residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. In addition, the base erosion test would provide protection from certain potential abuses of a Portuguese conduit. On the other hand, implementation of the tests for treaty shopping set forth in the treaty raise factual, administrative, and other issues. The Committee wishes to emphasize, however, that the new rules must be im-

plemented so as to serve as an adequate tool for preventing possible treaty-shopping abuses in the future.

F. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

The exchange of information article contained in the proposed treaty is very similar to the corresponding article of the OECD model treaty. The exchange of information article of the U.S. model, as compared to that article in the OECD model (and in the proposed treaty) provides for a somewhat broader scope of information exchange. For example, the U.S. model contains a clause that requires each treaty country to assist in the collection of taxes to the extent necessary to ensure that treaty benefits provided by the other country are enjoyed only by persons entitled to those benefits under the treaty. In providing such assistance, the U.S. model does not impose on the other country an obligation to carry out administrative measures that are at variance with its internal measures for tax collection, or that are contrary to its sovereignty, security, or public policy. Assistance in collection can be useful, for example, in a case where an entity located in a country with which the United States has a treaty serves as a nominee for a third-country resident. If the entity, on behalf of the third-country resident, receives a dividend from a U.S. corporation with respect to which a reduced rate of tax (as provided for by the proposed treaty) is inappropriately withheld, the entity, as a withholding agent, is technically liable to the United States for the underpaid amount of tax. However, without assistance from the government of the treaty country in which the entity is resident, enforcement of that liability may be difficult.

As part of its consideration of the proposed treaty, the Committee queried the Treasury Department regarding the rationale for the lack of the provision for assistance in collection under the proposed treaty. The relevant portion of Treasury's response to this inquiry, in the July 5, 1995 is reproduced below:

> 5. Why is there no provision for assistance in collection of withholding rates that were improperly reduced?
>
> The former U.S. model treaty included a limited assistance provision in which each country agreed to try to collect the difference between the treaty rate of withholding and the statutory rate and pay that difference over to the other country when the treaty rates were claimed by a person not entitled to them (*i.e.*, a resident of a third country). However, few countries are able to administer such a system. Moreover, increasingly, countries insist that if a collection assistance provision is included, it be much broader than that limited provision. We generally are unwilling to agree to such broader assistance. Therefore, several recent treaties omit this limited assistance provision.

The Committee has considered the information exchange provisions under the proposed treaty and believes that the provisions are adequate to allow the United States to properly determine the tax obligations of Portuguese persons, and to confine the benefits of the Portuguese treaty to those taxpayers entitled to receive them and has not recommended a reservation or understanding in this

case. However, the Committee believes that the exchange of information provisions in treaties are central to the purposes for which tax treaties are entered into, and it does not believe that significant limitations on their effect, relative to the preferred U.S. tax treaty position, should be accepted by the Administration in its negotiations with other countries that seek to have or maintain the benefits of a tax treaty relationship with the United States.

G. TRANSFER PRICING

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 reallocate profits among related enterprises residing in each country, if a reallocation is necessary to reflect the conditions which would have been made between independent enterprises. In addition, the proposed treaty requires each country to attribute to a permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty.[18] A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise. The arm's-length standard has been adopted uniformly by the leading industrialized countries of the world, in order to secure the appropriate tax base in each country and avoid double taxation, "thereby minimizing conflict between tax administrations and promoting international trade and investment."[19]

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[20] Some prefer a so-called "formulary apportionment" approach, which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an ap-

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[18] The OECD draft report on transfer pricing generally approves the methods that are incorporated in the current Treasury regulations under section 482 as consistent with the arm's-length principles upon which Article 9 of the proposed treaty is based. See OECD Committee on Fiscal Affairs, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators," OECD, Paris 1995.

[19] *Id.* (preface).

[20] See generally "The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing before the Senate Committee on Governmental Affairs," 103d Cong., 1st Sess. (1993) (hereinafter, Hearing Before the Senate Committee on Governmental Affairs).

proach that is based on the expectation that an investor generally will insist on a minimum return on investment or sales.[21]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimination rules embodied in Article 26.[22] Some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

As part of its consideration of the proposed treaty, the Committee requested the Treasury Department to provide additional information on the Administration's current policy with respect to transfer pricing issues. Among the information requested include a description of the Administration's general position on transfer pricing issues, an analysis of whether the United States should interpret Article 9 of tax treaties regarding transfer pricing as permitting other methods of pricing such as the unitary method or formulary apportionment method and the reasons for industry's support of the arm's-length pricing method. In addition, the Committee also inquired whether the Treasury Department is satisfied that the proposed treaty, and other treaties that are the subject of the hearing, ensure foreign corporations are paying their share of U.S. taxes. Relevant portions of Treasury's response to these inquiries, in the July 5, 1995 Treasury letter, are reproduced below:

> 1. Please describe the position of the U.S. Treasury with regard to the transfer pricing issue.
>
> While estimates of the magnitude of the problem vary, Treasury regards transfer pricing as one of the most im-

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[21] See "Tax Underpayment by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means," 101st Cong., 2d Sess. 360–61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also "Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means," 102d Cong., 2d Sess. (1992).

[22] Compare "Tax Conventions with: The Russian Federation, Treaty Doc. 102–39; United Mexican States, Treaty Doc. 103–7; The Czech Republic, Treaty Doc. 103–17; The Slovak Republic, Treaty Doc. 103–18; and The Netherlands, Treaty Doc. 103–6. Protocols Amending Tax Conventions with: Israel, Treaty Doc. 103–16; The Netherlands, Treaty Doc. 103–19; and Barbados, Treaty Doc. 102–41. Hearing Before the Committee on Foreign Relations, United States Senate," 103d Cong., 1st Sess. 38 (1993) ("A proposal to use a formulary method would be inconsistent with our existing treaties and our new treaties.") (oral testimony of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Treasury Department); a statement conveyed by foreign governments to the U.S. State Department that "[worldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State); and "American Law Institute Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties" (1992), at 204 (n. 545) ("Use of a world-wide combination unitary apportionment method to determine the income of a corporation is inconsistent with the Associated Enterprises article of U.S. tax treaties and the OECD model treaty") with Hearing Before the Senate Committee on Governmental Affairs at 26, 28 ("I do not believe that the apportionment method is barred by any tax treaty that the United States has now entered into.") (statement of Louis M. Kauder). See also "Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means," 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

portant international tax issues that it faces. Treasury believes that both foreign and U.S.-owned multinationals have engaged in significant income shifting through improper transfer pricing.

Treasury identified three problems that allowed these abuses to occur: (1) lack of substantive guidance in U.S. regulations for taxpayers and tax administrators to apply in cases where the traditional approaches did not work; (2) lack of an incentive for taxpayers to attempt to set their transfer prices in accordance with the substantive rules; and (3) lack of international consensus on appropriate approaches. To resolve these problems, Treasury has taken the following steps in the last two years:

> In July 1994, Treasury issued new final regulations under section 482 of the Internal Revenue Code. These regulations contain methods that were not reflected in prior final regulations: the Comparable Profits and Profit Split Methods. These methods are intended to be used when the more traditional methods are unworkable or do not provide a reliable basis for determining an appropriate transfer price.
>
> In August 1993, Congress enacted a Treasury proposal to amend section 6662(e) of the Internal Revenue Code. This provision penalizes taxpayers that both (1) are subject to large transfer pricing adjustments and (2) do not provide documentation indicating that they made a reasonable effort to comply with the regulations under section 482 in setting their transfer prices. Treasury issued temporary regulations implementing the statute in February 1994.
>
> In July 1994, the Organization for Economic Cooperation and Development issued a draft report on transfer pricing. The United States is an active participant in this body. The OECD transfer pricing guidelines serve as the basis for the resolution of transfer pricing cases between treaty partners and it therefore is critical that any approach adopted in any country be sanctioned in this report in order to reduce the risk of double taxation. The draft report permits the use of the new U.S. methods in appropriate cases.

2. Why shouldn't the United States interpret Article 9 of the tax treaties regarding transfer pricing as permitting other methods of pricing such as the unitary or formulary apportionment method?

If Treasury adopted such an interpretation, it would send a signal to our treaty partners that we were moving away from the arm's-length standard to a different, more arbitrary approach. Sending such a signal would be very destructive and, if implemented, would inevitably result in double (and under) taxation due to the fundamental inconsistency between the approach used in the United States and that used elsewhere. Further, adopting such an interpretation would invite non-OECD countries to introduce

their own approaches that currently cannot be foreseen, but that could inappropriately increase their tax bases at the expense of the United States and other countries.

3. The consensus regarding transfer pricing methods is currently the arm's-length standard. Will the U.S. remain open to the possibility of better or alternative methods without moving to such alternative methods unilaterally?

If it appeared that another approach was superior to the current approach, the U.S. would push for the adoption of this new approach on a multilateral basis so that there would be the necessary international consensus in favor of the new approach.

4. Why does industry support the arm's-length pricing method?

Most multinationals are willing to pay their fair share of tax. Their primary concern is that they not be subjected to double taxation. Because the arm's-length standard is the universally adopted international norm and the major countries of the world have adopted a consensus interpretation of that standard within the OECD, the risks of double taxation are infinitely smaller under the arm's-length standard than under any other approach.

5. A recent GAO report suggested that many foreign corporations are not paying their fair share of taxes. Is Treasury satisfied that these treaties ensure full payment of required taxes?

A tax treaty by itself will not prevent transfer pricing abuses. Rather, the treaty leaves it to the internal rules and practices of the treaty partners to deal with such issues. In the United States, Treasury has taken the measures described above to ensure that foreign—and domestic—corporations pay their fair share of taxes. A tax treaty can make these internal measures more effective, particularly through the exchange of information provisions that enable the U.S. tax authorities to obtain transfer pricing information on transactions between related parties in the United States and the treaty partner. The treaties also facilitate Advance Pricing Agreements that preclude the possibility of double taxation and at the same time ensure that each country receives an appropriate share of the taxes paid by a multinational.

H. RELATIONSHIP TO URUGUAY ROUND TRADE AGREEMENTS

The multilateral trade agreements encompassed in the Uruguay Round Final Act, which entered into force as of January 1, 1995, include a General Agreement on Trade in Services ("GATS"). This agreement generally obligates members (such as the United States and Portugal) and their political subdivisions to afford persons resident in member countries (and related persons) "national treatment" and "most-favored-nation treatment" in certain cases relating to services. The GATS applies to "measures" affecting trade in services. A "measure" includes any law, regulation, rule, procedure, decision, administrative action, or any other form. Therefore, the

obligations of the GATS extend to any type of measure, including taxation measures.

However, the application of the GATS to tax measures is limited by certain exceptions under Article XIV and Article XXII(3). Article XIV requires that a tax measure not be applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services. Article XIV(d) allows exceptions to the national treatment otherwise required by the GATS, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other members. "Direct taxes" under the GATS comprise all taxes on income or capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises as well as taxes on capital appreciation.

Article XXII(3) provides that a member may not invoke the GATS national treatment provisions with respect to a measure of another member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between members as to whether a measure falls within the scope of such an agreement between them, either member may bring this matter before the Council for Trade in Services. The Council is to refer the matter to arbitration; the decision of the arbitrator is final and binding on the members. However, with respect to agreements on the avoidance of double taxation that are in force on January 1, 1995, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to the tax agreement.

Article XIV(e) allows exceptions to the most-favored-nation treatment otherwise required by the GATS, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the member is bound.

The proposed protocol provides, in paragraph 1, that notwithstanding any other agreement to which the United States and Portugal are parties, a dispute concerning whether a measure is within the scope of the proposed treaty is to be considered only by the competent authorities under the dispute settlement procedures of the proposed treaty. Moreover, the proposed treaty provides that the nondiscrimination provisions of the proposed treaty are the only nondiscrimination provisions that may be applied to a taxation measure unless the competent authorities determine that the taxation measure is not within the scope of the proposed treaty (with the exception of nondiscrimination obligations under the General Agreement on Tariffs and Trade ("GATT") with respect to trade in goods).

The Committee believes that it is important that the competent authorities are granted the sole authority to resolve any potential dispute concerning whether a measure is within the scope of the proposed treaty and that the nondiscrimination provisions of the proposed treaty are the only appropriate nondiscrimination provisions that may be applied to a tax measure unless the competent

authorities determine that the proposed treaty does not apply to it (except nondiscrimination obligations under GATT with respect to trade in goods). The Committee also believes that the provision of the proposed treaty is adequate to preclude the preemption of the mutual agreement provisions of the proposed treaty by the dispute settlement procedures under the GATS.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to have a minimal increase on annual Federal budget receipts during the fiscal year 1995–2000 period.

VIII. Explanation of Proposed Treaty and Protocol

For a detailed article-by-article explanation of the proposed tax treaty and protocol, see the "Treasury Department Technical Explanation of the Convention and Protocol Between the United States of America and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income Signed at Washington on September 6, 1994."

IX. Text of the Resolution of Ratification

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the Government of the United States of America and the Portuguese Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, together with a related Protocol, signed at Washington on September 6, 1994 (Treaty Doc. 103–34). The Senate's advice and consent is subject to the following two understandings, both of which shall be included in the instrument of ratification to be signed by the President and the following two declarations, neither of which shall be included in the instrument of ratification to be signed by the President:

(a) Understanding: That if the Portuguese Republic changes its internal policy with respect to government ownership of commercial banks in a manner that has the effect of exempting from U.S. tax the U.S.-source interest paid to Portuguese commercial banks under paragraph 3(b) of Article 11, the Government of Portugal shall so notify the Government of the United States and the two Governments shall enter into consultations with a view to restoring the balance of benefits under the proposed Convention;

(b) Understanding: That the second sentence of paragraph 2 of article 2 of the proposed Convention shall be understood to include the specific agreement that the Portuguese Republic regularly shall inform the Government of the United States of America as to the progress of all negotiations with and actions taken by the European Union or any representative organization thereof, which may affect the application of paragraph 3(b) of article 10 of the proposed Convention;

(c) Declaration: That the United States Department of the Treasury shall inform the Senate Committee on Foreign Relations as to the progress of all negotiations with and actions taken by the European Union or any representative organization thereof, which may affect the application of paragraph 3(b) of article 10 of the proposed Convention; and

(d) Declaration: That it is the Sense of the Senate that

(1) the effect of the Portuguese Substitute Gift and Inheritance Tax is to provide for nonreciprocal rates of tax between the two parties;

(2) such nonreciprocal treatment is a significant concession by the United States that should not be viewed as a precedent for future U.S. tax treaties, and could in fact be a barrier to Senate advice and consent to ratification of future treaties;

(3) the Portuguese Government should take appropriate steps to insure that interest and dividend income beneficially owned by residents of the United States is not subject to higher effective rates of taxation by Portugal than the corresponding effective rates of taxation imposed by the United States on such income beneficially owned by residents of Portugal; and

(4) the United States should communicate this Sense of the Senate to the Portuguese Republic.

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