[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY AND PROPOSED PROTOCOL BETWEEN THE UNITED STATES AND PORTUGAL

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON MAY 25, 1995

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty, as modified by the proposed protocol, between the United States and the Portuguese Republic ("Portugal"). The proposed treaty and proposed protocol were both signed in Washington, D.C., on September 6, 1994. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty (and protocol) on May 25, 1995.

No income tax treaty between the United States and Portugal is in force at present.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model")[2], and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those documents.

Part I of the pamphlet summarizes the principal provisions of the proposed treaty and protocol. Part II is a discussion of issues presented by the proposed treaty and protocol. Part III provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. For a copy of the proposed treaty and protocol, see Senate Treaty Doc. 103-34, September 19, 1994. For a detailed, article-by-article explanation of the proposed 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," May 1995 (hereinafter "Technical Explanation").

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and Portugal* (JCS–14–95), May 23, 1995.

[2] The U.S. model has been withdrawn from use as a model treaty by the Treasury Department. Accordingly, its provisions may no longer represent the preferred position of U.S. tax treaty negotiations.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.

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and 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 promote close economic cooperation between the two countries and to facilitate trade and investment between the two countries. It is intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these 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 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).

Summary of treaty provisions

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 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 would be treated as a resident of neither the United States nor Portugal for 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 would 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 would 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 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 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, interest, 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 agrees 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 gross-basis dividend withholding tax rate 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 with 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 Avenca*) 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."[3] 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. That is, 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 (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 (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 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 (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% or a

[3] 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."

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 would 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.

Staff understand 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.[4]

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 would not receive a new basis in remitted property for all purposes, but rather would be required to keep records establishing the value of remitted property at the time of remittance. The United States would 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 real property 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 mov-

[4] 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 19th and 20th of December, 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):

> c. 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.

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able 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 would 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 would 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 in-

dividual residents of the country of residence of the entity,[5] and (b) do not use a substantial portion of their income to meet liabilities of persons who are not residents of either treaty country and who are not 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 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

[5] 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.

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 would be 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 would be 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 twelve 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 contain 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., income 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 would take precedence over the corresponding provisions of any other agreement between the United States and Portugal in determining whether a law or other rule is within the scope of the proposed treaty. Unless the competent authorities agree that the law or other rule is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the most-favored-nation or national-treatment rules of any trade or investment agreement in effect between the United States and Portugal, generally would apply to that law or rule. The only exception to this general rule is that the most-favored-nation and national-treatment rules of the General Agreement on Tariffs and Trade would 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.

(40) The proposed treaty generally will take effect on January 1 of the year following ratification (Article 30).

II. ISSUES

The proposed treaty between the United States and Portugal, as amended by the proposed protocol, presents the following specific issues.

A. Developing Country Concessions

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax 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, would permit 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) would create 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 would be 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 would create 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 will be 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 would include payments for the use of, or the right to use, industrial, commercial, or scientific equipment.[6] 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 would permit 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.[7]

Issue presented

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.

The issue is whether these developing country concessions represent appropriate U.S. treaty policy and, if so, whether Portugal is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with developing countries. A number of existing U.S. income tax treaties with developing countries already

[6] 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.

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

include similar concessions. Such concessions may be necessary in order to obtain treaties with developing countries. Tax treaties with developing countries can be in the interest of the United States because they provide developing country tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

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 payors to U.S. recipients than the rate that the United States may impose on similar payments from U.S. payors 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 "Most-Favored-Nation 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 would be 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 will be 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 sub-

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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.*

stitute 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 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 is, in substance, a supplemental 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 discussed below, the treatment of the Portuguese substitute gift and inheritance tax as a creditable tax may exacerbate the problem by reducing U.S. tax revenues.)

Fundamentally, consideration should be given to whether agreeing to nonreciprocal treaty rates for dividends and potentially interest represents appropriate U.S. tax treaty policy and, if so, whether Portugal is an appropriate recipient of this concession. There is a risk that, if the proposed treaty is ratified, the inclusion of this concession could result in additional pressure on the United States to include nonreciprocal rates in future treaties with other countries. There is at least one prior U.S. tax treaty that provides a similar concession. Article 13 of the U.S.-Philippines treaty allows the Philippines to tax most royalties at a rate of 25 percent but limits the U.S. rate to 15 percent.

Creditability of the substitute gift and inheritance tax

The Internal Revenue 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 allowing 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

[12] See the discussion in the following section regarding the creditability of the Portuguese substitute gift and inheritance tax against U.S. income 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 Portuguese substitute gift and inheritance tax will not be disqualified as an income tax creditable for U.S. tax purposes by virtue of the characterization of the tax by Portugal as a gift or inheritance tax. 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:

> 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]

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 country. 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 that Portugal may apply to dividends paid to residents of European Union ("EU") member countries, but not below 5 percent. Staff understands that

[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.

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 would have 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.

The reduction in withholding tax rate contemplated by this provision is consistent with U.S. tax policy. The fact that the timing of this reduction will be established without the participation of the United States is unusual. The issue is whether the Committee is comfortable with the self-executing nature of this provision, or alternatively, should seek an understanding that any reduction in the source country tax rate on direct investment dividends, resulting from modifications in the tax rates in effect between Portugal and EU countries, would take effect only after an exchange of notes or other consultations between Portugal and the United States.

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 to 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 staff 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 staff 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 would exempt 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 staff, 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 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 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 business 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.

The issue here is whether agreeing to treaty exemption for interest from commercial activities of government-owned entities represents appropriate U.S. tax treaty policy and, if so, whether Portugal is an appropriate recipient of this concession. There is a risk that, if the proposed treaty is ratified, the inclusion of this provision could result in additional pressure on the United States to include similar provisions in future treaties with other countries. This provision may be of greater concern in a treaty with a country that maintains greater government ownership of commercial banks than does Portugal at the present time. There is at least one other

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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.

[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).

U.S. tax treaty that provides for a similar rule (see Article 10 of the U.S.-China treaty).

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 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, including the other treaties that are the subject of this hearing. 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 pro-

posed 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.

The Committee continues to believe that United States should maintain its policy of limiting treaty-shopping opportunities whenever possible. The provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Portugal; for example those investors may be unwilling to share ownership of such investing entities on an equal basis with U.S. or Portuguese residents or other qualified owners in order to meet the ownership test. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative or other issues that cannot currently be foreseen. Thus, the Committee may wish to satisfy itself that provision as proposed is 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 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.

The issue is whether the Committee views the exchange of information rules contained in the proposed treaty as sufficient to carry out the tax-avoidance purpose for which income tax treaties are entered into by the United States. Due to the proposed protocol's reference to the exchange of bank records, 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, the proposed treaty may provide some assurance that Portugal will take whatever measures are possible under its tax laws to obtain information for the benefit of the United States.

With respect to the absence of a reciprocal tax collection provision, the Committee may wish to consider the extent to which absence of such a provision adversely affects U.S. efforts to confine Portuguese treaty benefits to persons entitled to those benefits. The absence of collection assistance in this treaty also may decrease the United States' ability to obtain the desired level of collection assistance in treaty negotiations with other countries.

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

[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

Continued

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 approach 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

on Fiscal Affairs, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, Discussion Draft of Part I: Principles and Methods," 1994.

[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*).

[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 "[w]orldwide 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 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).

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.

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 Por-

tugal 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).

Inasmuch as this provision of the proposed treaty (and the corresponding provision of other proposed treaties) is unprecedented, the Committee may wish to satisfy itself that the proposed treaty provision is adequate to preclude the preemption of the mutual agreement provisions of the proposed treaty by the dispute settlement procedures under the GATS.

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

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

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level excess interest tax, which amounts to 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (generally including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called "withholding taxes").

Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions from withholding taxes are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless the interest is effectively connected with the conduct of a U.S. trade or business carried on by the recipient. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio debt obli-

gations is exempt from the 30-percent tax. Certain U.S. income tax treaties also provide for exemption from tax in certain cases.[23]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real estate.

The source of income received by nonresident alien individuals and foreign corporations is determined under rules contained in the Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, interest paid by that person will be foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation are generally treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend will be considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient of a dividend to the extent of such U.S. source portion unless a treaty prevents application of the branch profits tax on the paying Corporation.)

Rents and royalties paid for the use of property in the United States are considered U.S. source income. The property used can be either tangible property or intangible property (e.g., patents, secret processes and formulas, franchises and other like property).

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions of the

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[23] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons and the amount of interest paid on obligations guaranteed by related tax-exempt persons.

Code contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis (as opposed to a "per-country" basis). Pursuant to rules enacted as part of the Tax Reform Act of 1986 ("1986 Act"), the overall limitation is computed separately for certain classifications of income (i.e., passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the residual U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

Prior to the Deficit Reduction Act of 1984 ("1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided lookthrough rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic taxable income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction).

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

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the gen-

erally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if each country considers the same deduction allocable to income that it treats as foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation--situations where either country taxes income received by nonresidents at rates that exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross basis. (Most countries, like the United States, generally tax domestic source income on a gross basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax exceeds the tax that would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal.

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

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base in that jurisdiction. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to

pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent withholding tax and agrees to reduce this tax (or in the case of some income, eliminate it entirely) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. Such a treaty provision generally is referred to as a so-called "saving clause." Double taxation also may arise, notwithstanding the existence of a treaty, because most countries will not exempt passive income from tax at the source.

Double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

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

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

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

"anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

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

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