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

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INTRODUCTION

This is a technical explanation of the Convention between the United States and Portugal signed on September 6, 1994 (the "Convention"). The Convention is based on the U.S. Treasury Department's former draft Model Income Tax Convention, published on June 16, 1981, the Model Tax Convention on Income and Capital published by the OECD in 1992 (the "OECD Model"), and recent U.S. and Portuguese income tax conventions. Although the former U.S. Model has been withdrawn pending development of a new model, it was relevant at the time during which much of the Convention was negotiated.

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

The terms "he" or "his" should be read to mean also "she" or "her."

Article 1. GENERAL SCOPE

This article provides that the Convention is applicable to residents of the United States or Portugal except where the terms of the Convention provide otherwise. Under Article 4 (Resident), a person is treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of domicile or other similar criteria, subject to certain limitations. If a person is, under those criteria, a resident of both Contracting States, a single State of residence (or no State of residence) is assigned under Article 4. These rules govern for all purposes of the Convention. Certain provisions of the Convention are also applicable, however, to persons who may not be residents of either Contracting State. Examples include Articles 26 (Non-Discrimination) and 28 (Exchange of Information).

Paragraph 1 of the Protocol contains the other provisions normally included in the General Scope Article of U.S. income tax treaties. Subparagraph 1(a)(i) of the Protocol explains that the Convention may not restrict any exclusion, exemption, deduction, credit, or other benefit accorded by the tax laws of the Contracting States. In effect, subparagraph 1(a)(i) provides that the Convention may not increase the overall tax burden on a resident of a Contracting State beyond the burden imposed under domestic law. Thus, a right to tax granted by the Convention to a Contracting State cannot be exercised unless the domestic law of that State also provides for such taxation.

Under the principle of subparagraph 1(a)(i), a taxpayer's U.S. tax liability need not be determined under the Convention if the Internal Revenue Code would produce a more favorable result. This does not mean, however, that a taxpayer may pick and choose among Code and Convention provisions in an inconsistent manner in order to minimize tax. For example, suppose a Portuguese resident has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that earn taxable income under the Code but do not meet the permanent establishment threshold tests of the Convention. One trade or business is profitable, and the other incurs a loss. Under the Convention, the income of the permanent establishment would be taxable, and both the profit and the loss of the other two businesses would be ignored. Under the Code, all three would be taxable and the loss would be offset against the profits of the two profitable ventures. In this situation, the taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 308.) If the taxpayer invokes the Code for the taxation of all three ventures, however, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Subparagraph 1(a)(i) of the Protocol also provides that the Convention does not override any benefit provided under other bilateral agreements that were in force as of the date on which the Convention was signed (September 6, 1994).

Subparagraph 1(a)(ii) of the Protocol affects obligations undertaken by the Contracting States under other agreements. Subparagraph 1(a)(ii) of the Protocol provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning whether a measure is within the scope of this Convention shall be considered only by the competent authorities of the Contracting States, as defined in this Convention, and the procedures under this Convention exclusively shall apply to the dispute. Thus, dispute resolution procedures provided for in trade, investment, or other agreements between the Contracting States shall not apply for the purpose of determining the scope of the Convention.

Subparagraph 1(a)(iii) of the Protocol provides that, unless the competent authorities agree that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation ("MFN") obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade ("GATT"). No national treatment or MFN obligation under any other agreement shall apply with respect to that measure. Thus, any national treatment and MFN obligations undertaken by the Contracting States under agreements other than the Convention, with the exception of GATT as applicable to trade in goods, shall not apply to a taxation measure.

Subparagraph 1(a)(iv) of the Protocol defines a "measure" as a law, regulation, rule, procedure, decision, administrative action, or any other form of measure.

Subparagraph 1(b) of the Protocol contains the traditional U.S. treaty "saving clause." Under this paragraph, each Contracting State may tax its residents, and the United States may tax its citizens, in accordance with its domestic law, notwithstanding any Convention provision to the contrary. If, for example, a Portuguese resident performs independent personal services in the United States and the income from the services is not attributable to a fixed base in the United States, Article 14 (Independent Personal Services) would normally prevent the United States from taxing the income. If, however, the Portuguese resident is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under normal Code rules (i.e., without regard to Code section 894(a)). Special foreign tax credit rules concerning U.S. taxation of certain income of U.S. citizens resident in Portugal are provided in paragraph 2 of Article 25 (Relief from Double Taxation).

For purposes of the saving clause of paragraph 1(b) of the Protocol, residence is determined under Article 4 (Resident).

Subparagraph 1(b) of the Protocol states that the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for the period of 10 years following such loss. This permits the United States to apply the rules of Code section 877. Subparagraph 1(b) of the Protocol concludes by providing that, upon request by the Portuguese competent authority, the competent authorities will consult under Article 27 (Mutual Agreement Procedure) on the purposes of such loss of citizenship. Thus, if the United States taxes a former U.S. citizen who is a resident of Portugal, the Portuguese competent authorities may request a discussion with their U.S. counterparts of the circumstances involved in the case.

Subparagraph 1(c) of the Protocol lists several exceptions to the saving clause, under which benefits granted by a Contracting State under the Convention are extended to its citizens and residents. Under subparagraph 1(c)(i), U.S. residents and citizens are entitled to the following U.S. benefits provided under the Convention: the corresponding adjustments authorized by paragraph 2 of Article 9 (Associated Enterprises); the provisions of paragraph 3 of Article 14 (Capital Gains) regarding gain from the alienation of certain property; the exemption from U.S. tax of social security benefits paid by Portugal that is provided in subparagraph 1(b) of Article 20 (Pensions, Annuities, Alimony, and Child Support); the exemption from U.S. tax of child support payments paid by a Portuguese resident that is provided in paragraph 4 of Article 20 (Pensions, Annuities, Alimony, and Child Support); the foreign tax credit provisions of Article 25 (Relief from Double Taxation); the nondiscrimination protection of Article 26 (Non-Discrimination); and the competent authority procedures of Article 27 (Mutual Agreement Procedure).

Subparagraph 1(c)(ii) of the Protocol provides additional exceptions to the saving clause for individuals resident in a Contracting State who are neither citizens of, nor have immigrant status in, that State. These exceptions preserve the benefits extended by the United States under the Convention to persons other than U.S. citizens and "green card" holders who are: employees of the Portuguese Government under Article 21 (Government Service); visiting teachers or researchers under Article 22 (Teachers and Researchers); visiting students or trainees under Article 23 (Students and Trainees); or members of diplomatic or consular missions under Article 29 (Diplomatic Agents and Consular Officers).

Article 2. TAXES COVERED

This Article identifies the U.S. and Portuguese taxes to which all articles of the Convention apply. Certain provisions of the Convention and the Protocol are also applicable, however, with respect to certain taxes in addition to those specified in Article 2. For example, Article 26 (Non-Discrimination) applies with respect to all taxes imposed at all levels of government, including state and local governments. Article 28 (Exchange of Information) applies with respect to all taxes imposed by a Contracting State (i.e., at the national level). Paragraph 8 of the Protocol applies with respect to the substitute gift and inheritance tax (Imposto sobre Sucessoes e Doacoes por Avenca) imposed by Portugal.

In the case of Portugal, the Convention generally applies to the personal income tax (Imposto sobre o Rendimento das Pessoas Singulares-IRS), the corporate income tax (Imposto sobre o Rendimento das Pessoas Colectivas-IRC), and the local surtax on corporate income tax (Derrama). As noted above, other provisions, such as Articles 26 (Non-Discrimination) and 28 (Exchange of Information) of the Convention and paragraph 8 of the Protocol, apply to certain additional taxes.

In the case of the United States, the Convention generally applies to the Federal income taxes imposed by the Internal Revenue Code. The Convention applies to the excise taxes imposed with respect to the investment income of private foundations under Code sections 4940 et seq., but does not apply with respect to the excise taxes imposed on insurance premiums paid on policies issued by foreign insurers under Code section 4371. The social security taxes provided in Code sections 1401, 3101, and 3111 are generally excluded from coverage. However, as noted above, certain other provisions of the Convention, such as Articles 26 (Non-Discrimination) and 28 (Exchange of Information), apply to all taxes imposed by the United States, including the insurance premiums excise taxes and the social security taxes. In addition, as in other U.S. treaties, Article 26 (Non-Discrimination) applies to taxes imposed by state and local governments.

Under paragraph 2 of Article 2 (Taxes Covered), the Convention will apply to any taxes that are identical or substantially similar to those enumerated in paragraph 1 and that are imposed in addition to, or in place of, the existing taxes after September 6, 1994 (the date of signature of the Convention). Paragraph 2 also provides that the U.S. and Portuguese competent authorities will notify each other of changes in their taxation laws that are of significance to the operation of the Convention. The competent authorities will also notify each other of official published materials concerning the application of the Convention.

Paragraph 2 of the Protocol provides additional information regarding taxes that are and are not covered. Paragraph 2(a) of the Protocol clarifies that Article 2 does not apply to social security contributions established under Portuguese law. These amounts are not covered because, as under the U.S. system, they are treated as contributions to Portugal's social security system, not as taxes. As noted above, Article 2 itself makes clear that U.S. social security contributions are not covered.

Subparagraph 2(b) of the Protocol limits the application of the Convention with respect to the personal holding company tax (Code section 541) and the accumulated earnings tax (Code section 531). Subparagraph 2(b)(i) exempts a Portuguese company from liability for the personal holding company tax only for taxable years in which all of the Portuguese company's stock is owned by individuals who are not residents or citizens of the United States, in their capacity as individuals. Thus, if there is any owner that is not an individual, or any owner that is a U.S. citizen or U.S. resident, the Portuguese company may be liable for the personal holding company tax. Under subparagraph 2(b)(ii) of the Protocol, Portuguese companies that are described in paragraph 1(c) of Article 17 (Limitation on Benefits), which pertains to certain publicly traded companies, are exempt from the accumulated earnings tax. In general, this is intended to relieve such a Portuguese company from any obligation to prove that its earnings and profits have not accumulated beyond the reasonable needs of the company. It is understood that such publicly traded companies are unlikely to be mere holding or investment companies and that the interests of the shareholders of such companies are likely to operate so as to prevent an unreasonable accumulation of earnings and profits.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines a number of basic terms used in the Convention. Certain other terms are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Resident). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends," "interest," and "royalties" are defined in Articles 10 (Dividends), 11 (Interest), and 12 (Royalties), respectively. The introductory language makes clear that the definitions specified in paragraph 1 apply for all purposes of the Convention, unless the context otherwise requires. The latter condition allows flexibility in interpretation of the treaty in order to avoid results not intended by the treaty's negotiators.

Subparagraph 1(a) defines the term "Contracting State" to mean the United States or Portugal, depending on the context in which the term is used.

Subparagraph 1(b) defines the term "Portugal" to mean the Portuguese Republic. This includes the territory on the European Continent and the archipelagoes of Azores and Madeira, the respective territorial seas and any other zone in which, in accordance with the laws of Portugal and international law, the Portuguese Republic has sovereign rights with respect to the exploration and exploitation of the natural resources of the seabed and subsoil and of the superjacent waters.

Subparagraph 1(c) defines the term "United States" to mean the United States of America. The term does not include Puerto Rico or the Virgin Islands, Guam, or any other U.S. possession or territory. When used in a geographical sense, the term "United States" includes the States, the District of Columbia, the territorial sea adjacent to those States, and any other zone adjacent thereto over which, in accordance with the laws of the United States and international law, the United States has sovereign rights with respect to the exploration and exploitation of the natural resources of the seabed and subsoil and of the superjacent waters.

Subparagraph 1(d) defines the term "person" to include an individual, a company, and any other body of persons. This definition is consistent which that used in the OECD Model and in other U.S. treaties. Any person that qualifies as a "resident" of a Contracting State under Article 4 (Resident) is entitled to the benefits of the Convention, subject to the provisions of Article 17 (Limitation on Benefits).

Subparagraph 1(e) defines the term "company" as any body corporate or any entity treated as a body corporate for tax purposes. In the case of the United States, the rules of Treas. Reg. §301.7701-2 generally will apply to determine whether an entity is an association taxable as a corporation, and thus is a company, for purposes of the Convention. Similarly, in the case of the United States, a publicly traded partnership that is treated as a corporation under Code section 7704 will be treated as a company for purposes of the Convention.

Subparagraph 1(f) defines the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" to mean an enterprise carried on by a resident of the appropriate Contracting State. Thus, an enterprise of a Contracting State need not be carried on in that State. It may be carried on in the other State or in a third state.

Subparagraph 1(g) defines the term "national" to mean any individual possessing the nationality of a Contracting State and any legal person, association, or other entity deriving its status as such from the laws in the force in a Contracting State. This definition, which comes from the OECD Model, has been used in other U.S. treaties. In the case of the United States, the term "national" means a U.S. citizen when applied to an individual.

Subparagraph 1(h) defines the term "international traffic" to mean any transport by a ship or aircraft, except when such transport is solely between places within a Contracting State. The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that the transport of goods or passengers solely between New York and Chicago by a Portuguese carrier (if permitted) would not be treated as international traffic. If, however, goods or passengers were carried by a Portuguese airline from Lisbon to New York and then to Chicago, the entire trip would be considered international traffic. This would be true even if a Portuguese carrier transferred goods at the U.S. port of entry from a ship or plane to a land vehicle, or if the overland portion of the trip in the United States were handled by an independent carrier under contract with the Portuguese carrier, so long as both parts of the trip were reflected in the original bill of lading.

Subparagraph 1(i) defines the term "competent authority." The competent authorities of the Contracting States are charged with administering the provisions of the Convention and with attempting to resolve any doubts or difficulties that may arise in interpreting its provisions. The U.S. competent authority is the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, delegated the authority to the Assistant Commissioner (International). With respect to interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. In Portugal, the competent authority is the Minister of Finance, the Director General of Taxation (Director Geral das Contribuicoes e Impostos), or their authorized representative.

Paragraph 2 of Article 3 provides that, in the application of the Convention, any term used but not defined in the Convention will have the meaning that it has under the tax law of the Contracting State whose tax is being applied. If, however, the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Convention, the competent authorities may, pursuant to paragraph 3 of Article 27 (Mutual Agreement Procedure), agree to a common meaning in order to prevent double taxation or further any other purpose of the Convention. Likewise, if the definition of a term under either paragraph 1 of

Article 3 or the tax law of a Contracting State would result in a circumstance unintended by the treaty negotiators or by the Contracting States, the competent authorities may agree to a common meaning of the term. This common meaning need not conform to the meaning of the term under the laws of either Contracting State.

Article 4. RESIDENT

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter, only residents of the Contracting States may claim the benefits of the Convention. However, the fact that a person is determined to be a resident of a Contracting State under Article 4 does not necessarily entitle that person to the benefits of the Convention. In addition to being a resident, a person must qualify for benefits under Article 17 (Limitation on Benefits).

Under paragraph 1, the determination of residence for Convention purposes looks first to a person's liability to tax as a resident under the taxation laws of the Contracting State involved. Thus, a person that is liable to tax under the laws of a Contracting State by reason of its domicile, residence, place of management, place of incorporation, or any other similar criterion is treated as a resident of that State. A person that, under those laws, is a resident of one Contracting State and not of the other generally need look no further.

Paragraph 1 concludes with an exception to the general rule of this paragraph. A person that is liable to tax in a Contracting State only in respect of income from sources within that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a Portuguese consular official who is posted in the United States, and who is subject to U.S. tax on U.S. source investment income but not on non-U.S. source income, would not be considered a resident of the United States for purposes of the Convention. (In most cases, such an individual also would not be a U.S. resident under the Code.)

Paragraph 2 provides a series of tie-breaker rules to determine a single State of residence for an individual who, under the laws of each Contracting State, and thus under paragraph 1, is deemed to be a resident of both Contracting States. These rules, which are generally included in U.S. treaties, come from the OECD Model. The first rule establishes residence where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State with which his personal and economic relations are closest, *i.e.*, the location of his "center of vital interests." If this test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither, he will be treated as a resident of the Contracting State of which he is a citizen. If he is a citizen of both States or of neither, the competent authorities are instructed to determine his residence by mutual agreement.

Paragraph 3 seeks to settle dual-residence issues for persons other than individuals. A corporation is treated as a resident in the United States if it is created or organized under the laws of the United States or a political subdivision thereof. In Portugal, a corporation is treated as a resident of Portugal if it is either incorporated there or managed and controlled there. Dual residence, therefore, can arise if a U.S.-incorporated corporation is managed in Portugal. Since neither party was prepared to give up its test of corporate residence under a tie-breaker rule, the paragraph provides that if a corporation or other person, other than an individual, is resident in both the United States and Portugal under paragraph 1, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. If, however, they are unable to reach agreement, that person shall not be considered to be a resident of either the United States or Portugal for purposes of deriving any benefits of the Convention. Since it is only for the purposes of deriving treaty benefits that such dual residents are excluded from the Convention, they may be treated as resident for other purposes. For example, if a dual resident corporation pays a dividend to a resident of Portugal, the U.S. withholding agent would be permitted to withhold on that dividend at the appropriate treaty rate, since reduced withholding is a benefit enjoyed by the resident of Portugal, not by the dual resident. The dual resident corporation that pays the dividend would, for this purpose, be treated as a resident of the United States under the Convention.

Paragraph 3 of the Protocol provides further guidance on the issue of residence. Under subparagraph 3(a) of the Protocol, a partnership, similar pass-through entity, estate, or trust will be treated as a resident of a Contracting State to the extent that the income derived by the partnership, similar pass-through entity, estate, or trust is subject to tax in that State as the income of a resident, whether in the hands of the entity deriving the income or in the hands of its partners, members, beneficiaries, or grantors. This rule is applied to determine the extent to which income received by or through an estate, trust, partnership, or similar pass-through entity such as a U.S. limited liability company, from the other Contracting State is entitled to Convention benefits.

Under U.S. law, partnerships (other than certain publicly traded limited partnerships and partnerships that are classified as associations under Treas. Reg. § 301.7701-2) are never, and estates and trusts often are not, taxable entities. Thus, for Convention purposes, income received by a U.S. partnership generally is treated as received by a U.S. resident only to the extent that it is included in the distributive share of partners who are U.S. residents (looking through any partnerships that are themselves partners). Similarly, the treatment under the Convention of income received by a U.S. trust or estate will be determined by the residence for taxation purposes of the person subject to tax on such income, which may be the grantor, the beneficiaries, or the estate or trust itself, depending on the circumstances.

Subparagraph 3(b)(i) of the Protocol confirms that the term "resident of a Contracting State" includes any not-for-profit organization constituted and maintained in that State, provided that the laws of such State or of a political or administrative subdivision thereof limit the use of the organization's resources, both currently and upon the dissolution or liquidation of such organization, to the accomplishment of the purposes that serve as the basis for such organization's exemption from income tax. Subparagraph 3(b)(ii) of the Protocol similarly confirms that a pension trust or any other organization or arrangement that is constituted and operated exclusively to provide pension, retirement, or employee benefits and that is established or sponsored by a person that is otherwise a resident of a Contracting State under Article 4 (Residence) is to be treated as a resident of that State for purposes of the Convention. This is the case notwithstanding the fact that all or part of the income of the organization, trust, or other arrangement may be exempt from income tax under the domestic laws of that State.

Under subparagraph 3(c) of the Protocol, a U.S. citizen or a nonresident alien lawfully admitted for permanent residence (a "green card" holder) will be treated as a U.S. resident by Portugal for purposes of the Convention only if such individual has a substantial presence in the United States or would be treated as a resident of the United States and not of a third country under the principles of subparagraphs (a) and (b) of paragraph 2 of Article 4 (Residence). Therefore, a U.S. citizen or "green card" holder whose permanent home, center of vital interests, and habitual abode are neither in the United States nor in Portugal, and who does not have a substantial presence in the United States, generally will not be entitled to benefits under the Convention. (However, as noted above in connection with Article 1 (Personal Scope), limited Convention benefits are available to certain persons who are not residents of either Contracting State.)

The Article does not contain the explicit provision, found in some U.S. treaties, that the government of a Contracting State is a resident of that State. It was not considered necessary to clarify this point, because it is understood by both Portugal and the United States that the Government of each Contracting State and political or administrative subdivisions and local authorities thereof are residents of that State for purposes of the Convention.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant to several articles of the Convention. For example, under Article 7 (Business Profits), a Contracting State may not tax the business profits of a resident of the other Contracting State unless that resident has a permanent establishment in the first Contracting State. Articles 10 (Dividends), 11 (Interest), and 12 (Royalties) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base that the recipient has in the source State. If the income is attributable to a permanent establishment, Article 7 (Business Profits) applies, and if the income is attributable to a fixed base, Article 14 (Independent Personal Services) applies.

Paragraph 1 provides the basic definition of the term "permanent establishment." As used in the Convention, the term means a fixed place of business through which the business of an enterprise is wholly or partly carried on. In the case of an individual, Article 15 (Independent Personal Services) uses the concept of a "fixed base," rather than a "permanent establishment," but the two concepts are considered to be similar.

Paragraph 2 contains a list of examples of fixed places of business that constitute a permanent establishment: a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources. The use of singular nouns in this illustrative list is not meant to imply that each such place of business constitutes a separate permanent establishment. In the case of mines or wells, for example, several such places of business could constitute a single permanent establishment if the project forms a commercial and geographical whole.

Paragraph 3 adds that the term "permanent establishment" also includes a building site or a construction installation or assembly project, supervisory activities in connection with such a site or project, or an installation or drilling rig or ship used for the exploration or development of natural resources, but only if such site, project, or activities last more than 6 months. This 6-month threshold applies separately to each individual site or project. The testing period begins when work (including preparatory work carried on by the resident) physically begins in a Contracting State. A series of contracts or projects that are commercially and geographically interdependent are to be treated as a single project. For example, the construction of a housing development would be considered a single project even if each house were constructed for a different purchaser. Likewise, the drilling of several wells within the same geographic area would be considered a single permanent establishment. If the 6-month threshold is exceeded, the site or project constitutes a permanent establishment from its first day. This interpretation of the Article is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which constitute the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention.

Paragraph 4 provides that, notwithstanding the preceding provisions of this Article, an enterprise of a Contracting State that carries on business of a permanent nature in the other Contracting State through its own employees or any other personnel engaged for such purpose for a period or periods totalling 9 months or more in any 12-month period commencing or ending in the taxable year concerned shall be deemed to have a permanent establishment in the other State. In this context, "business of a permanent nature" is intended to suggest business other than that of a preparatory or auxiliary character. The 9-month rule of this paragraph is, however, limited by paragraph 4 of the Protocol, which states that the provisions of this paragraph shall apply only for the first 5 years in which the provisions of the Convention have effect. For example, if the Convention were to enter into force on July 3, 1995, paragraph 4 of Article 5 (Permanent Establishment) would be in effect only for taxable periods beginning on or after January 1, 1996 and before January 1, 2001.

Paragraph 5 is drawn directly from the OECD Model and lists a number of activities that may be carried on through a fixed place of business but that, nevertheless, will not give rise to a permanent establishment. Under subparagraph 5(a), the use of facilities solely to store, display, or deliver merchandise belonging to an enterprise will not constitute a permanent establishment of that enterprise. Under subparagraphs 5(b) and 5(c), the maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display, or delivery, or solely for the purpose of processing by another enterprise will not give rise to a permanent establishment of the first-mentioned enterprise. Under subparagraphs 5(d) and 5(e), the maintenance of a fixed place of business solely for purchasing goods or collecting information for the enterprise, or for carrying out any other activity of a preparatory or auxiliary character for the enterprise (e.g., advertising, the supply of information, or certain research activities) will not constitute a permanent establishment of the enterprise. Finally, under subparagraph 5(f), a combination of the activities described in paragraph 5 will not give rise to a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. This is the same as the corresponding provision in many other U.S. income tax treaties, as well as in the OECD Model.

Paragraphs 6 and 7 specify when the activities of an agent will give rise to a permanent establishment. Under paragraph 6, an enterprise will be deemed to have a permanent establishment as a result of the activities of a dependent agent if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, the agent's activities are limited to those activities specified in paragraph 5 that would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the activities of the agent will not cause the enterprise to be deemed to have a permanent establishment.

Under paragraph 7, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent.

Paragraph 8 provides that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other State or that carries on business in that other State. The determination of whether a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 7 of the Article and paragraph 4 of the Protocol. Whether a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

Article 6. INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

Paragraph 1 provides the general rule that income derived by a resident of a Contracting State from immovable property (real property) located in the other Contracting State, including income from agriculture or forestry, may be taxed in that other State. The income may also be taxed in the State of residence. Thus the Article does not grant an exclusive taxing right to the situs State, but merely grants it the primary right to tax.

Paragraph 2 defines the term "immovable property" or "real property" by reference to the domestic law of the situs State. In addition, the paragraph specifies certain classes of property that, regardless of domestic law definitions, are to be included within the meaning of the term for purposes of the Convention. It also specifies that the term "real property" does not include ships or aircraft in any event.

Paragraph 3 clarifies that all forms of income from the exploitation of real property are taxable in the situs State, including but not limited to income from direct use of real property by the owner and rental income from the letting of real property. Income from the disposition of real property, however, is not considered to be income derived from real property and is not covered by this Article. The taxation of such amounts is addressed in Article 14 (Capital Gains). Similarly, interest paid on a mortgage on real property and distributions by a U.S. real estate investment trust are not considered to be income derived from real property. The taxation of these items is addressed in Articles 10 (Interest) and 11 (Dividends), respectively.

Paragraph 4 clarifies that income from real property of an enterprise is covered by this Article and not by Article 7 (Business Profits). Similarly, income from real property used for the performance of independent personal services is covered by this Article and not by Article 14 (Independent Personal Services). Thus, the situs State may tax the real property income of a resident of the other State even if such income is not attributable to a permanent establishment or fixed base of an enterprise of that resident in the situs State.

The provision in the former U.S. Model for a binding election by the taxpayer to be taxed on real property income on a net basis was not included in the Convention. Portugal permits taxation on a net basis only if the income is attributable to a permanent establishment. Otherwise, tax is imposed on the gross amount, subject to a withholding of 25 percent by the payer. This is similar to the situation with Spain.

Paragraph 5 of the Protocol clarifies that the provisions of Article 6 also apply to income from associated personal property and from the provision of services for the maintenance or operation of real property.

Article 7. BUSINESS PROFITS

This Article provides rules for the taxation by a Contracting State of the business profits of an enterprise of the other Contracting State. Paragraph 1 provides the general rule that business profits of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on or has carried on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. Where that condition is met, the State in which the permanent establishment is situated may tax the business profits of the enterprise, but only so much as is attributable to that permanent establishment.

Paragraph 2 provides that the Contracting States will attribute to a permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment and with any other associated enterprise. The computation of business profits attributable to a permanent establishment under this paragraph is subject to the rules of paragraph 3 for the allowance of expenses incurred for purposes of earning the income.

Profits attributable to a permanent establishment are taxable in the State where the permanent establishment is situated or was situated at the time the profits were derived. This rule incorporates the rule of Code section 864(c)(6) with respect to deferred payments, which is also reflected in the provisions of Articles 11 (Interest), 13 (Royalties), 15 (Independent Personal Services), and 24 (Other Income) dealing with amounts attributable to a permanent establishment or fixed base. If income is attributable to a permanent establishment or fixed base, it is taxable by the State where the permanent establishment or fixed base was located, even if the income is deferred (i.e., not taken into account) until the permanent establishment or fixed base has ceased to exist.

The concept of "attributable to" in paragraph 2 is analogous to, but somewhat narrower than, the concept of "effectively connected" in Code section 864(c). For example, the profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, Code section 864(c)(3) is consistent with paragraph 2, i.e., the items of foreign source income described in Code section 864(c)(4)(B) may be attributed to a U.S. permanent establishment of a Portuguese resident and subject to tax in the United States. The limited "force of attraction" rule in Code section 864(c)(3) is not applicable under the Convention, however, because only those profits attributable to a permanent establishment's assets or activities may be taxed by the Contracting State in which the permanent establishment is located.

Paragraph 3 provides that, in determining the business profits of a permanent establishment, deductions shall be allowed for expenses that are incurred for the purposes of the permanent establishment. These include expenses directly incurred by the permanent establishment and a reasonable allocation of expenses incurred by the home office, or by other permanent establishments of the home office, as long as the expenses were incurred for the purposes of the permanent establishment. Such expenses include, but are not limited to, research and development expenses, interest, and executive and general administrative expenses, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment.

In connection with paragraph 3, paragraph 6 of the Protocol confirms that it is understood that each Contracting State may apply its own domestic law, whether based on tracing or allocation, for attributing research and development expenses, interest, and other similar expenses to a permanent establishment situated in its territory, provided that such rules are consistent with the provisions of Article 7. This language confirms that the United States may apply its expense allocation rules under Treas. Reg. §§ 1.861-8 and 1.882-5.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment that performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable to it with respect to its purchasing activities. If the sole activity of the office were the purchasing of goods or merchandise for the enterprise, however, the issue of the attribution of income would not arise. Under subparagraph 5(d) of Article 5 (Permanent Establishment), the office would not be a permanent establishment to which profits could be attributed.

Paragraph 5 is intended to assure consistent tax treatment over time for permanent establishments by providing that profits shall be determined by the same method of accounting each year, unless there is good reason to change the method used. This provision, however, does not restrict a Contracting State from imposing additional requirements on a permanent establishment, as provided in its law, in the event of a change in accounting method, to prevent amounts from being duplicated or omitted (see, e.g., Code section 481).

Paragraph 6 coordinates the provisions of this Article and other provisions of the Convention. Under paragraph 6, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those other articles will take precedence over the provisions of Article 7, except where they specifically provide to the contrary. Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest), and not by Article 7, except where (as provided in paragraph 6 of Article 11) the interest is attributable to a permanent establishment.

This Article is subject to the "saving clause" of subparagraph 1(b) of the Protocol. Thus, if a citizen of the United States who is a resident of Portugal under the Convention derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 3 of Article 24 (Relief from Double Taxation), tax those profits, notwithstanding the provisions of this Article.

Article 8. SHIPPING AND AIR TRANSPORT

This Article governs the taxation of profits from the operation of ships and aircraft in international traffic. Under paragraph 1, profits derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic are taxable only in that State. By virtue of paragraph 6 of Article 7 (Business Profits), profits of an enterprise of a Contracting State that are exempt in the other Contracting State under this paragraph are exempt in that other State even if the enterprise has a permanent establishment there.

Paragraph 2 clarifies that the provisions of paragraph 1 apply to income from participation in a pool, joint business, or international operating agency. This refers to various arrangements for international cooperation by carriers in shipping and air transport. For example, if the Portuguese airline, TAP, were to form a consortium with airlines of other countries, the Portuguese participant's share of the total income derived by the consortium from U.S. sources would be covered by this Article.

Paragraph 7 of the Protocol clarifies what income is to be considered profits from the operation of ships or aircraft. It specifies that the term "income from the operation of ships or aircraft in international traffic" is to be interpreted in accordance with paragraphs 5 to 12 of the Commentary to Article 8 of the 1992 OECD Model. As such, it is understood that full charters of ships and aircraft used in international traffic are covered by paragraph 1. International shipping profits include rents from bareboat charters made by shipping and aircraft companies only when such charters are occasional and incidental to the international traffic operations of those companies. Rental income from bareboat charters that are not occasional and incidental to the lessor's international traffic operations are not covered by this Article, but may be covered by other articles of the Convention, such as Article 13 (Royalties) or Article 7 (Business Profits). Thus, if an oil company that owns a deep-water tug (used in its offshore oil explorations) were to make a bareboat rental of that tug during periods of idle use, the income from such rental would not be covered by Article 8 because such company is not normally engaged in international traffic. It is also understood that the occasional and incidental leasing of terminal facilities for the loading and unloading of cargo or passengers would be auxiliary activity covered by the definition of international shipping profits if carried on by an operating company.

The "profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic" include those profits accruing to the enterprise that are attributable to transport between places in the other Contracting State when such transport is in connection with or incidental to transport outside of the other Contracting State, regardless of whether such transport is actually conducted by the enterprise. That is, because such transport is not solely between places within the other Contracting State but, rather, is in connection with or incidental to transport outside of the other Contracting State, such transport is covered by the definition of international traffic. For example, when a shipping enterprise of a Contracting State undertakes to provide, in connection with such transport, for the transshipment and delivery by rail of the transported goods to a consignee within the other Contracting State and derives profits from either direct payments by the consignee or commissions from the transshipment agent, such profits are part of the shipping enterprise's profits from the international traffic and, as such, are not taxable in the other Contracting State.

Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers, and related equipment for the transport of containers, used for the transport of goods or merchandise in international traffic are treated as royalties, unless attributable to a permanent establishment. However, paragraph 11 of the Protocol provides that such royalties are taxable only by the Contracting State of which the recipient is a resident. It is understood that in the context of paragraph 11 of the Protocol, the term "containers" includes related equipment incidental to the transport of containers, such as cranes and trailers.

Article 9. ASSOCIATED ENTERPRISES

This Article incorporates into the Convention the general principles of Code section 482. It provides generally that when a resident of one Contracting State engages in transactions with a related person resident in the other Contracting State, and such transactions are not conducted on an arm's length basis, the

Contracting States may make appropriate adjustments to the taxable income and tax liability of such persons to reflect the income or tax liability with respect to such transactions that each person would have had if the relationship between them had been at arm's length.

Paragraph 1 deals with the circumstances where an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State, or when the same persons participate directly or indirectly in the management, control, or capital of an enterprise of one Contracting State and of an enterprise of the other Contracting State. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable. If, in either circumstance, the two enterprises make or impose conditions in their commercial or financial relations that differ from the conditions that would exist in relations between independent enterprises, the competent authorities may adjust the income of the related enterprises to reflect the profits that would have accrued to either enterprise if the two enterprises had been independent of each other.

Paragraph 2 provides that, where a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, the other Contracting State will make an appropriate corresponding adjustment to the tax liability of the related enterprise in that other State. It is understood that the other Contracting State need adjust its tax only if it agrees that the initial adjustment under paragraph 1 is appropriate. The Contracting State making a corresponding adjustment under this paragraph will take the other provisions of the Convention into account. For example, if the effect of a corresponding adjustment is to treat a Portuguese corporation as having made a distribution of profits to its U.S. parent corporation, the provisions of Article 10 (Dividends) will apply to that distribution. The competent authorities are authorized to consult, if necessary, to resolve any differences in the application of this paragraph.

Paragraph 2 of Article 27 (Mutual Agreement Procedure) requires that any corresponding adjustment made under paragraph 2 of this Article be implemented notwithstanding any time limits or procedural limitations in the law of the Contracting State making the adjustment.

The "saving clause" of subparagraph 1(b) of the Protocol does not apply to paragraph 2 of this Article. Thus, U.S. benefits are also available to U.S. citizens and residents. Therefore, even if the statute of limitations has run, or there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax may be made in order to implement a corresponding adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because, under subparagraph 1(a) of the Protocol, the Convention cannot restrict any statutory benefit.

Paragraph 3 simply confirms that this Article does not restrict the provisions of either Contracting State's domestic law relating to the determination of the tax liability of a person, provided that the determination is consistent with the principles stated in this Article, i.e., that the adjustment reflects what would have transpired had the related parties been acting at arm's length. Thus, a Contracting State is free to make adjustments to losses or credits, for example, to the extent permitted under its domestic law and the arm's-length principles of this Article, although such adjustments are not specified in paragraph 1.

Article 10. DIVIDENDS

This Article provides rules for the taxation of dividends paid by a company resident in one Contracting State to a resident of the other Contracting State. The article permits full residence State taxation and limited source State taxation of such dividends.

Paragraph 1 preserves the residence State's general right to tax its residents on dividends paid by a company that is a resident of the other Contracting State.

Paragraph 2 grants the source State the right to tax dividends paid by a company that is a resident of that State to a beneficial owner that is a resident of the other Contracting State. The source State tax is limited to 15 percent of the gross amount of the dividend. Use of the term "beneficial owner" emphasizes that substance will prevail over form in determining the appropriate tax treatment, so that treaty benefits may be denied to a nominal recipient not entitled to the beneficial enjoyment of the dividend income.

In the absence of such a provision, the United States would apply its statutory withholding rate of 30 percent to dividends paid to a Portuguese resident, and Portugal would apply its statutory withholding rate of 25 or 15 percent to dividends paid to a U.S. resident.

Paragraph 2 also provides that the competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this rate limitation. For example, they may agree on procedures whereby determinations are made as to who is entitled to the reduced withholding rate under this provision.

Paragraph 2 does not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Paragraph 3 provides for a lower rate of taxation at source if the beneficial owner is a company that is a resident of the other Contracting State and that, for an uninterrupted period of 2 years prior to the payment of the dividend, owned directly at least 25 percent of the capital of the company paying the dividends. (The 25-percent ownership requirement and the 2-year holding period correspond to Portugal's threshold for entitlement to receive a 95-percent dividends received deduction.) It is understood that in the case of the United States "capital" refers to voting power. In the case of Portugal, "capital" refers to "social capital," the nominal paid-in value of the company's shares. The lower rate applicable to these dividends is 10 percent of the gross amount with respect to dividends paid after December 31, 1996 and before January 1, 2000. With respect to dividends paid after December 31, 1999, the rate for each of the Contracting States will be the rate Portugal may apply to such dividends paid to residents of European Union member states provided, however, that the applicable rate shall not be less than 5 percent. It is understood by both the United States and Portugal that the term "paid" means paid or credited.

Under its domestic law, Portugal also imposes a 5 percent substitute gift and inheritance tax (Imposto sobre Sucessoes e Doacoes por Avenca) on dividends paid by certain types of companies. (Portuguese legislation currently extends the 5 percent substitute gift and inheritance tax to certain types of interest, but the tax has not yet been imposed on interest payments and was recently deferred again.) That tax is not covered in this or any other Portuguese income tax treaty. However, paragraph 8 of the Protocol provides that if in the future the rate of tax is increased above 5 percent, that increase will not apply to dividends owned by residents of the United States. Portugal has never before agreed to lower this tax by treaty or to exempt a treaty partner from future rate increases. The fact that Portugal regards this substitute tax as a gift or inheritance tax, as indicated by the Protocol, does not affect the determination as to whether the tax is creditable for U.S. income tax purposes.

Paragraph 4 provides an exception to paragraph 3 for dividends paid by a U.S. regulated investment company (RIC) or real estate investment trust (REIT). A dividend paid by a RIC is subject to the 15 percent portfolio dividend rate, regardless of the percentage of voting shares of the RIC held directly by the recipient of the dividend. The purpose of the reduction of the direct investment dividend rate is to relieve multiple levels of corporate taxation in cases where the recipient of the dividend holds a substantial interest in the payer. This rationale does not justify a reduction of the rate in the case of dividends paid by RICs, because RICs do not pay corporate tax with respect to amounts distributed to their shareholders. Further, although certain amounts received by a RIC may have been subject to U.S.

corporate tax (e.g., dividends paid by a publicly traded U.S. company to a RIC), it is unlikely that a 25 percent shareholding in a RIC by a Portuguese resident will correspond to a 25 percent shareholding in the entity (here, the publicly traded U.S. company) that has paid U.S. corporate tax. Thus, in the case of dividends received by a RIC and paid out to its shareholders, the requirement of a substantial shareholding in the entity paying the corporate tax is presumed not to be satisfied.

In the case of a dividend paid by a U.S. REIT to a Portuguese resident, the U.S. statutory rate of 30 percent generally applies (except in the case of amounts subject to tax as effectively connected income under Code section 897(h)). Dividends beneficially owned by an individual holding a less than 25 percent interest in the REIT are eligible, however, for the 15 percent portfolio dividend rate provided in paragraph 2. The denial of the 15 percent portfolio rate to corporate shareholders and 25 percent or greater individual shareholders is intended to prevent indirect investment in U.S. real property through a REIT from receiving more favorable treatment than direct investment in such real property.

Paragraph 5 defines the term "dividends," as used in this Article, to include income from any shares, "jouissance" rights, mining shares, founders' shares, or other rights that are not debt claims and that participate in profits, and income from other corporate rights that is subjected to the same taxation treatment as income from shares by the domestic laws of the Contracting State of which the company making a distribution is a resident. This is consistent with the definition used in many U.S. treaties and in the OECD Model. Paragraph 5 adds that income from arrangements, including debt obligations, will also be a dividend, if such arrangements carry the right to participate in profits and the income is characterized as a dividend under the domestic law of the Contracting State in which the income arises. In the case of Portugal, the term also includes profits attributed under an arrangement for participation in profits (associacão en participacão).

Paragraph 6 provides that, where dividends are attributable to a permanent establishment or fixed base that the beneficial owner maintains in the source State, they are not subject to the provisions of paragraph 1, 2, and 3 of this Article, but instead are taxable under Article 7 (Business Profits) or Article 15 (Independent Personal Services), as appropriate. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the Contracting State in which the permanent establishment or fixed base is located, as modified by the Convention.

Under paragraph 7, where a company that is a resident of a Contracting State derives profits or income from the other

Contracting State, that other State may not impose tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State.

Article 11. INTEREST

Paragraph 1 confirms that interest may be taxed by the State in which the recipient is resident. Paragraph 2 provides that interest arising in a Contracting State may also be taxed by that State in accordance with its laws. However, if the beneficial owner of such interest is a resident of the other Contracting State, then any tax so charged may not exceed 10 percent of the gross amount of the interest. Use of the term "beneficial owner" emphasizes that substance will prevail over form in determining the appropriate tax treatment, to deny treaty benefits to a nominal recipient not entitled to the beneficial enjoyment of the interest.

In the absence of paragraph 2, Portugal generally would tax interest at 20 percent, and the United States would impose its 30 percent statutory withholding rate on interest other than portfolio interest.

Paragraph 2 also provides that the competent authorities shall agree on how to implement this Article, for example on procedures whereby determinations are made as to who is entitled to the reduced withholding rate provided by this Article (Interest).

Paragraph 3 provides three cases where source-based taxation of interest is eliminated: (1) when the debtor is the government of the Contracting State, a political or administrative subdivision thereof, or any of its local authorities; (2) when the recipient of the interest arising in a Contracting State is the government of the other Contracting State, its political subdivisions, or local authorities, or an institution or organization wholly owned by them; and (3) when the interest is on a loan with a term of 5 years or more granted by a bank or other financial institution that is a resident of the other Contracting State. The second exemption, where the creditor is the other government, a subdivision or local authority thereof, or a wholly government-owned institution is broader than the exemption provided under Code section 892, but is similar to the rule in several other U.S. income tax treaties. It is principally intended to benefit Eximbank and OPIC. Under its domestic law, Portugal would tax interest paid to those U.S. Government lending institutions.

Paragraph 9 of the Protocol reserves the right of the United States to tax an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC) in accordance with its law. Thus, Portuguese residents will be taxed on such excess inclusions at the U.S. statutory rate of withholding tax (i.e., 30 percent).

Paragraph 4 provides an exception to paragraphs 2 and 3 whereby interest arising in one of the Contracting States that is determined by reference to the profits of the issuer or of one of its associated enterprises and that is beneficially owned by a resident of the other Contracting State may be taxed in the State in which it arises, and according to the laws of that State, but the tax so charged shall not exceed the 15-percent rate prescribed in paragraph 2 of Article 10 (Dividends).

Paragraph 5 defines the term "interest," as used in the Convention, to include income from debt claims of every kind, whether or not secured by a mortgage, and, subject to paragraph 5 of Article 10 (Dividends), whether or not carrying a right to participate in profits. The term "interest" includes, in particular, income from government securities, income from bonds or debentures, any premiums or prizes attaching to such securities, bonds or debentures, and all other income treated as interest by the taxation law of the source State. The definition does not refer to penalties and fines for late payment, which are frequently excluded from the treaty definition of interest.

Paragraph 6 provides an exception from the general rule of paragraph 1 in cases where the beneficial owner of the interest, who is a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base situated in that other State and the interest is attributable to that permanent establishment or fixed base. In such a case, the income is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), respectively. This rule applies even if the permanent establishment or fixed base no longer exists when the interest is taken into account, as long as the interest would have been attributable to the permanent establishment or fixed base if it had been taken into account in the earlier year (i.e., where the debt claim on which the interest is paid was attributable to the permanent establishment in such earlier year).

Paragraph 7 provides a source rule for interest for purposes of this Article. Under this paragraph, interest is deemed to arise in a Contracting State when the payer is a resident of that State or the State itself, or a political or administrative subdivision or local authority thereof. Where, however, the payer (whether or not a resident of a Contracting State) has in a

Contracting State a permanent establishment or fixed base, and the interest is borne by such permanent establishment or fixed base, then the interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Paragraph 8 provides that if, as a result of a special relationship between the payer and the beneficial owner of the interest, or between both of them and some other person, the interest paid is excessive, Article 11 applies only to the amount of interest payments that would have been made absent such special relationship (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the laws of the United States and Portugal, respectively, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend, rather than as interest, subject to the provisions of Article 10 (Dividends).

Article 12. BRANCH TAX

Article 12 and paragraph 10 of the Protocol explicitly confirm the right of each Contracting State to impose a branch tax, that is, a tax imposed by a Contracting State on the earnings of an enterprise of the other Contracting State through a permanent establishment in the first Contracting State. Such a branch tax imposed on payments or deemed payments from branch to home office is analogous to the withholding taxes that would be imposed on the dividends and interest payments made by a subsidiary to a parent corporation.

In the case of the United States, paragraph 1(a) defines the amount of branch profits subject to the tax as the portion of the business profits of the corporation attributable to a permanent establishment in the United States--or subject to tax in the United States on a net basis under Article 6 (Income from Immovable Property (Real Property)) or paragraph 1 of Article 14 (Capital Gains)--that represents the "dividend equivalent amount" (see Code section 884(b)).

Paragraph 1(b) also covers both interest paid and excess interest payments, as defined by Code section 884(f), deemed to be received by a Portuguese corporation for which deductions are allowable for purposes of determining income attributable to its U.S. permanent establishment (or taxable on a net basis in the United States as income from real property or gain on real property), to the extent such deductible amounts exceed the interest paid by the permanent establishment or trade or business.

Paragraph 2 provides the rate at which tax may be imposed on the "dividend equivalent amount" and the interest amounts described in paragraph 1. For the "dividend equivalent amount," the rate shall not exceed 15 percent (or, after 1997, the lower rate applicable under paragraph 3 of Article 10 (Dividends)). In general, branch interest may be taxed at not more than 10 percent. However, in recognition of the withholding tax exemption for long-term bank loans under Article 11 (Interest), the rate with respect to excess interest amounts of the U.S. permanent establishment of a Portuguese bank is limited to 5 percent, an average of the general 10 percent rate and the exemption applicable to interest on long-term bank loans. A similar average rate has been used for this purpose in other U.S. treaties, including the recent treaty with Spain.

Portugal does not presently impose a branch tax. However, paragraph 10 of the Protocol provides complementary treatment for Portugal with respect to the branch profits taxes described in paragraphs 1 and 2 in the event that Portugal enacts a branch profits tax in the future.

Article 13. ROYALTIES

Article 13 confirms that royalties may be taxed by the Contracting State in which the recipient is resident. Royalties arising in a Contracting State may also be taxed by that State in accordance with its laws. However, if the beneficial owner of such royalties is a resident of the other Contracting State, then any tax so charged may not exceed 10 percent. Use of the term "beneficial owner" emphasizes that substance will prevail over form in determining the appropriate tax treatment, so that treaty benefits may be denied to a nominal recipient not entitled to the beneficial enjoyment of the royalty income.

In the absence of paragraph 2, Portugal would apply its statutory withholding rate of 25 or 15 percent on royalties and the United States would impose its statutory rate of 30 percent.

Paragraph 2 provides that the competent authorities may agree on procedures whereby determinations are made as to who is entitled to the reduced withholding rate provided in this Article.

Paragraph 3 defines the term "royalties" as used in the Convention. The term "royalties" includes payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematographic films or films or tapes and other means of image or sound reproduction, any patent, trademark, design or model, plan, secret formula or process, or other like right or property; for the use or the right to use industrial, commercial, or scientific equipment; or for information concerning industrial, commercial, or scientific experience. The reference to "other means" of reproduction makes clear that subsequent technological advances will not affect the treatment of payments relating to the use of such means of image or sound reproduction from the definition of royalties. The definition of royalties also includes payments for technical assistance performed in a Contracting State by a resident of the other State where such assistance is related to the application of any such right or property. In addition, the term "royalties" includes gains derived from the use of such right or property to the extent that such gains are contingent on the productivity, use, or further disposition of the property.

The United States prefers to provide a treaty exemption at source for royalties arising in one Contracting State and derived and beneficially owned by a resident of the other Contracting State and to exclude equipment rental income from the definition of royalties. However, like a number of countries, Portugal objects strongly to these positions. The maximum treaty rate of 10 percent represents a significant reduction of the Portuguese domestic law rate. The United States has accepted this rate and equipment rental rule in other recent treaties (see, e.g., Mexico, Spain).

As noted earlier in the discussion of Article 8, paragraph 11 of the Protocol provides that royalties received in consideration for the use of, or the right to use containers in international traffic shall be taxable only in the Contracting State of which the recipient is a resident, unless attributable to a permanent establishment in the other Contracting State. (See below.)

Paragraph 4 provides an exception to the rules of paragraphs 1 and 2 in cases where a beneficial owner of royalties who is a resident of one Contracting State carries on or has carried on business through a permanent establishment in the other Contracting State or performs or has performed independent personal services through a fixed base in that other State and the royalties are attributable to that permanent establishment or fixed base, i.e., the right or property in respect of which the royalties are paid forms part of the business property of such permanent establishment or fixed base. In such a case, the royalties are taxable in accordance with the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), respectively, and the source State will generally retain the right of taxation. This rule applies even if the permanent establishment or fixed base no longer exists when the royalties are taken into account, as long as the royalties would have been attributable to the permanent establishment or fixed base if they had been taken into account in the earlier year (i.e., where the license in respect of which the royalties are paid was attributable to the permanent establishment in such earlier year).

Paragraph 5 provides rules for determining the source of royalty payments. Royalties paid by a resident of a Contracting State or by the government of a Contracting State, or a political or administrative subdivision or local authority thereof, generally are considered to have their source in that State. If the royalties are attributable to a permanent establishment or fixed base located in a Contracting State, they are sourced in that Contracting State provided that they are borne by such permanent establishment or fixed base. The term "borne by" is understood to mean allowable as a deduction in computing taxable income. However, when the royalties are not borne by a permanent establishment or fixed base located in a Contracting State and the payer is not a resident of either Contracting State, then the source of the royalties is the State in which the property or rights are used. These rules are a compromise between the U.S. statutory rule, which sources royalties in the State in which the property or rights are used, and the Portuguese rule, which sources royalties according to the residence of the payer. They permit the United States to tax a royalty paid by a third country resident to a resident of Portugal for the use of property in the United States. A taxpayer who prefers the source rule of the Code may choose to be taxed under the Code, as provided in paragraph 1(a)(i) of the Protocol. However, in that case the taxpayer may not claim the rate reduction under the treaty; the taxpayer must choose between either the treaty source and rate rules or the Code source and rate rules.

Paragraph 6 provides that if, as a result of a special relationship between the payer and the beneficial owner of a royalty, or between both of them and some other person, the royalty paid is excessive, Article 13 applies only to the amount of the royalty payment that would have been made absent such special relationship (i.e., an arm's length royalty payment). Any excess amount of royalty paid remains taxable according to the laws of the United States and Portugal, respectively, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits by a company under the domestic law of the source State, such excess amount will be taxed as a dividend, rather than as a royalty payment, subject to the provisions of Article 10 (Dividends).

Article 14. CAPITAL GAINS

This Article provides rules for source and residence State taxation of gains from the alienation of property.

Paragraph 1 provides that gains derived by a resident of one Contracting State from the alienation of real property situated in the other Contracting State may be taxed in the other (situs) State.

Paragraph 2 clarifies that the term "real property situated in the other Contracting State" is understood to include a United States real property interest when the United States is the "other Contracting State." Thus, the United States preserves its right to collect the tax imposed by Code section 897 on gains derived by foreign persons from the disposition of United States real property interests. For this purpose, the source rules of Code section 861(a)(5) shall determine whether a United States real property interest is situated in the United States. In addition, the paragraph clarifies that real property situated in Portugal includes stock, participations, or other rights in a company or other legal person the property of which consists, directly or indirectly, principally of immovable property situated in Portugal.

The provisions of paragraph 2 apply "for the purposes of paragraph 1" of this Article 14 (Capital Gains) and have no effect on the right of a Contracting State to tax income covered in other Articles. For example, the inclusion of interests in certain corporations in the definition of "real property situated in the other Contracting State" for purposes of permitting source country taxation of gains derived from dispositions of such interests under Article 14 does not affect the treatment of dividends paid by such corporations. Such dividends remain subject to the limitations on source State taxation contained in Article 10 (Dividends) and are not governed by the unlimited source State taxation right provided in Article 6 (Income from Immovable Property (Real Property)) with respect to real property.

Paragraph 3 preserves the right of the source State to tax gains from the alienation of movable (personal) property in certain circumstances. Under paragraph 3, gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has or had in the other Contracting State, or of movable property pertaining to a fixed base that is or was available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State. In the case of the United States, this preserves the taxing right of Code section 864(c)(7). In the case of Portugal, it preserves Portugal's statutory taxation of gain on property removed from a permanent establishment.

Subparagraph 12(a) of the Protocol acknowledges that the meaning of the term "business property," as used in this paragraph 3 of this Article, is narrower in some cases than that of the term "assets," used in paragraph 2 of this Article, despite the use in Portuguese of the same term in both places.

However, subparagraph 12(b) of the Protocol modifies paragraph 3 of the Convention by providing that removal of personal property from a Contracting State by an enterprise of the other Contracting State may be treated as an alienation of that property and taxed by the first-mentioned State only to the extent of the gains accrued on the property as of the date of removal. In this case, subsequent taxation by the State of residence of the enterprise is limited to the gains accruing after the time of removal from the first-mentioned Contracting State. For U.S. tax purposes, the taxpayer will carry over the basis of the property and will be required to substantiate its fair market value on the date of removal from Portugal in computing any subsequent gain that becomes taxable in the United States. This provision does not affect the operation of Code section 987 with respect to foreign currency gain or loss on remittances by a qualified business unit of property or currency. Under this provision, each Contracting State will limit its tax on the resident of the other Contracting State to the gain accrued on the property while in its territory. In the absence of this provision, there could be double taxation. Portugal would tax the gain accrued on the property as of the date on which property was removed from Portugal by an enterprise of the United States, and the United States would tax the full gain at the time the property was disposed of by the U.S. enterprise.

Subparagraph 12(c) of the Protocol ensures that a U.S. company that incorporates a branch in Portugal will receive the same beneficial treatment that Portugal is required to provide to a company resident in a member state of the European Union, i.e., deferral of the gain by carrying over to the subsidiary the basis of the assets of the branch. In the absence of such protection, Portugal would treat the reorganization in such a case as a taxable event and tax the gain on the assets of the branch at that time.

Paragraph 4 provides that gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic are taxable only in that State.

Paragraph 5 clarifies that gains from the alienation of any right or property described in Article 13 that are contingent on the productivity, use, or further disposition of the property, are taxable only in accordance with the provisions of Article 13, as provided in paragraph 3 of that Article.

Paragraph 6 grants to the residence State the exclusive right to tax gains from the alienation of property other than property referred to in paragraphs 1 through 5. Therefore, for example, gains from the sale of corporate shares that are not attributable to a permanent establishment of the seller in the other State will be taxable only in the State of residence of the seller.

Article 15. INDEPENDENT PERSONAL SERVICES

The Convention deals in separate articles with different classes of income from personal services. Article 15 generally deals with income from independent personal services, while Article 16 (Dependent Personal Services) generally deals with income from employment. Exceptions and additions to these general rules are provided for directors' fees in Article 18; for performance income of artistes and sportsmen in Article 19; for pensions in respect of personal service income and social security benefits in Article 20; for government service salaries and pensions in Article 21; for certain income of teachers and researchers in Article 22; and for certain income of students and trainees in Article 23.

Under paragraph 1, income derived by an individual who is a resident of one Contracting State from the performance of professional services in an independent capacity, or other independent activities, in the other Contracting State is exempt from tax in that other State unless either (a) the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his services, in which case the income attributable to that fixed base may be taxed in that other State, or (b) the individual remained in that other State for more than an aggregate of 183 days in any twelve-month period, in which case the income derived from the individual's activities performed in that other State may be taxed in that other State. The State of residence may tax in either case under subparagraph 1(b) of the Protocol. In addition, under that subparagraph of the Protocol, if the individual is a Portuguese resident who performs independent personal services in the United States, and the individual is also a U.S. citizen, the United States may tax his income without regard to the restrictions of this Article, subject to the special foreign tax credit rules of paragraph 2 of Article 25 (Relief from Double Taxation).

Paragraph 13 of the Protocol provides that the term "fixed base" used in paragraph 1 of Article 15 (Independent Personal Services) shall be interpreted according to paragraphs 3 and 4 of the Commentary on Article 14 (Independent Personal Services) of the 1992 OECD Model and of any guidelines that, for the application of such term, may be developed by the OECD in the future. These paragraphs explain that the meaning of "fixed base" is analogous to that of the term "permanent establishment." Therefore, the income attributed to a fixed base will be taxed in accordance with principles similar to those provided in Article 7 (Business Profits) for the taxation of business enterprises.

Paragraph 2 of Article 15 notes that the term "professional services" includes independent scientific, literary, artistic, educational, or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model and routinely included in U.S. treaties, is not exhaustive. The term includes all personal services performed by an individual for his own account, where he receives the income and bears the risk of loss arising from the services. However, the taxation of income from the types of independent services that are covered by Articles 18 through 23 is governed by the provisions of those articles.

Article 16. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation of remuneration derived by a resident of a Contracting State from the performance of personal services in the other Contracting State as an employee. However, the more specific rules of Articles 18 (Directors' Fees), 19 (Artistes and Sportsmen), 20 (Pensions, Annuities, Alimony, and Child Support), 21 (Government Service), 22 (Teachers and Researchers) and 23 (Students and Trainees) apply in the case of employment income described in one of these articles. Thus, even though the Contracting State in which employment income has its source generally has the right to tax such income under Article 16, it may not have the right to tax a particular type of income under the Convention if that right is limited by one of the aforementioned articles. Similarly, though a source State may have no general right of taxation under Article 16 with respect to a particular item of income, the State may have the right to tax that income under one of the aforementioned Articles.

Under paragraph 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed by his State of residence. However, to the extent that the remuneration is derived from an employment exercised (i.e., the performance of services) in the other Contracting State, the remuneration also may be taxed by that other State unless the conditions specified in paragraph 2 are satisfied.

Under paragraph 2, remuneration of an individual resident of a Contracting State that is derived from the performance of services as an employee within the other Contracting State may not be taxed by that other State if three conditions are satisfied: (a) the individual is present in that State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period that begins or ends in the taxable year concerned; (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that State; and (c) the remuneration is not borne by a permanent establishment or fixed base that the employer has in that State. If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer in a deductible payment, neither condition (b) nor condition (c) will be considered to have been fulfilled. Conditions (b) and (c) are intended to ensure that a Contracting State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received. In order for the remuneration to be exempt from tax in the source State, all three conditions must be satisfied.

Paragraph 3 contains a special rule applicable to remuneration for services performed by an individual who is a resident of a Contracting State as an employee aboard a ship or aircraft operated in international traffic. Such remuneration may be taxed only in the Contracting State of residence of the employee if the services are performed as a member of the regular complement of the ship or aircraft. The "regular complement" of a ship or aircraft includes the crew. In the case of a cruise ship, it may also include others, such as entertainers or lecturers, employed by the shipping company to serve on the ship. The use of the term "regular complement" is intended to clarify that a person who exercises his employment as, for example, an insurance salesman, while aboard a ship or aircraft or a person, such as an entertainer who visits the ship only temporarily during stopovers, is not covered by this paragraph.

If a U.S. citizen who is resident in Portugal performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a Portuguese ship or airline, and would therefore be exempt from U.S. tax if he were not a U.S. citizen, he is nevertheless taxable in the United States on his remuneration by virtue of the "saving clause" of subparagraph 1(b) of the Protocol, subject to the special foreign tax credit rules of paragraph 2 of Article 25 (Relief from Double Taxation).

Article 17. LIMITATION ON BENEFITS

Article 17 addresses the problem of "treaty shopping" by limiting the source basis tax benefits of the Convention to those residents of the other Contracting State that are either individuals or governmental entities or have a substantial business nexus with or a significant business purpose for residing in the other Contracting State. In a typical case of treaty shopping, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming treaty benefits with respect to that income. Article 17 limits the abuse of the Convention by limiting the benefits of the Convention to those persons whose residence in a Contracting State is not considered to have been motivated by the existence of the Convention. Absent Article 17, the entity generally would be entitled to benefits under the treaty as a resident of a Contracting State, although the entity might be denied those benefits as a result of limitations (e.g., business purpose, substance-over-form, step transaction, or conduit principles) applicable to the transaction or arrangement under the domestic law of the source State. Article 17 and the anti-abuse provisions of domestic law complement each other, as Article 17 generally determines whether a person has a sufficient nexus to the Contracting State to be entitled to benefits for treaty purposes, while domestic anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.

Article 17 follows the basic structure of the limitation on benefits articles in other recent treaties, such as the one with Germany. The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State, any one of which will entitle that person to benefits of the Convention. Paragraph 2 provides a test whereby other residents may be granted benefits with respect to certain items of income. Paragraph 3 provides that benefits also may be granted to a person not entitled to benefits under the tests of paragraph 1 or 2, if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Paragraph 4 defines the term "recognized securities exchange" as used in subparagraph 1(c). Paragraph 5 defines the term "gross income" as used in subparagraph 1(e)(ii). Paragraph 6 provides a special rule with respect to tax-free zones.

The first two categories of persons eligible for benefits from the other Contracting State under the Convention are individual residents of a Contracting State (subparagraph 1(a)) and the two Contracting States and their political subdivisions, local authorities, or wholly-owned institutions or organizations (subparagraph 1(b)). It is considered unlikely that persons falling into these two categories can be used improperly to derive treaty benefits on behalf of a third-country resident. If an individual is receiving income as a nominee on behalf of a third-country resident, benefits will be denied with respect to those items of income under the articles of the Convention that grant the benefit, because of the requirements in those articles that the beneficial owner of the income be a resident of a Contracting State.

The third category, described in subparagraph 1(c), consists of companies in whose principal class of shares there is substantial and regular trading on a recognized securities exchange (as defined in paragraph 4) and companies more than 50 percent of each class of whose shares are owned either by companies that are residents of either Contracting State, whose principal class of shares are so traded, or by persons referred to in subparagraph 1(b).

The fourth category, described in subparagraph 1(d), includes tax-exempt organizations, including not-for-profit organizations, private foundations, pension trusts, and other organizations and arrangements, described in subparagraph 3(b) of the Protocol, provided that more than half of the beneficiaries, members, or participants, if any, in such organization, trust, or arrangement are residents of that Contracting State who are entitled under this Article to benefits of the Convention.

The fifth category, described in subparagraph 1(e) of paragraph 1, includes persons who satisfy two tests: the so-called "ownership" and "base erosion" tests. The "ownership" test requires that more than 50 percent of the beneficial interest in the person (or, in the case of a company, more than 50 percent of the vote and value of each class of its shares) be ultimately beneficially owned by persons who are themselves entitled to benefits under the other tests of paragraph 1 or who are U.S. citizens. The "base erosion" test requires that less than 50 percent of the person's gross income (as defined in paragraph 5) be used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not entitled to benefits under the other tests of paragraph 1 or are not U.S. citizens.

The rationale for the two-part test of subparagraph 1(e) derives from the fact that treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others. In order to prevent such benefits from inuring substantially to third-country residents, it is not sufficient merely to require substantial ownership of the entity by treaty country residents or other qualified persons. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or other qualified persons. For example, a third-country resident could lend funds to a Portuguese-owned Portuguese corporation to be reloaned to the United States. The U.S. source interest income of the Portuguese corporation would be subject to a reduced U.S. withholding tax under Article 11 (Interest) of the Convention. While the Portuguese corporation would be subject to Portuguese income tax, its taxable income could be reduced to near zero by the deductible interest paid to the third-country resident. If, under a Convention between Portugal and the third country, that interest were exempt from Portuguese tax, the U.S. treaty benefit with respect to the U.S. source interest income would have flowed to the third-country resident.

Paragraph 2 provides that a person resident in one of the Contracting States may be entitled to benefits with respect to certain items of income derived from the other State if it is engaged in the active conduct of a trade or business in its State of residence and satisfies certain conditions. Such a person will be entitled to the benefits of the Convention with respect to an item of income derived from the other State if the income is derived in connection with, or is incidental to, the trade or business conducted in the State of residence and the trade or business is substantial in relation to the income-producing activity. This determination is made separately for each item of income derived from the other State.

The Convention does not define the term "substantial." As in the case of other recent Conventions, it is understood that it is not necessary that the activity in the State of residence be as large as the activity in the other State in order to be considered substantial. It must, however, represent more than a de minimis percentage of the activity in the other State, whether measured in terms of income, assets, or other similar measures. This requirement is intended to prevent the following type of abuse. If, for example, a third-country resident wants to acquire a U.S. company that manufactures televisions sets for worldwide markets, but the country of residence of the investor has no tax treaty with the United States, any dividends generated by the investment would be subject to a U.S. withholding tax of 30 percent. Absent a substantiality requirement, the investor could set up a Portuguese corporation that would operate a small outlet in Portugal to sell television sets manufactured by the company, and, in fact, sell a few sets per year and earn a very small amount of income. That Portuguese corporation could then acquire the U.S. manufacturer with capital provided by the third-country resident and produce a very large number of sets for sale in several countries, generating a much larger amount of income. It might attempt to argue that the U.S. source income is generated from business activities in the United States that are related to the television sales activity of the Portuguese parent, and that, therefore, the dividend income should be subject to a U.S. tax of 10 percent. In this example, however, the substantiality requirement would not be met, and the dividends would remain subject to withholding in the United States at a rate of 30 percent.

It is intended that the provisions of paragraphs 1 and 2 will be self-executing. Unlike the provisions of paragraph 3, discussed below, a claim of benefits under paragraph 1 or 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, determine on review that the taxpayer has improperly interpreted these paragraphs and is not entitled to the benefits claimed.

Paragraph 3 of Article 17 permits the competent authority of the State in which income arises to grant Convention benefits in additional cases, even if they do not meet the standards of paragraphs 1 or 2 (or sufficient information is not available to make such a determination). This discretionary provision is included in recognition that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third-country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended Convention benefits.

Paragraph 4 defines the term "recognized securities exchange" as used in subparagraph 1(c). In the case of the United States, this term means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934. In the case of Portugal, the term means the Lisbon and Oporto Stock Exchanges. The term "recognized securities exchange" also includes any other stock exchanges that may be agreed upon by the competent authorities.

Paragraph 5 defines the term "gross income," as used in subparagraph 1(e)(ii), generally to mean gross receipts. In the case of an enterprise engaged in a manufacturing or production business, the term "gross income" is defined to mean gross receipts reduced by the direct costs of labor and materials attributable to such manufacture or production and paid or payable out of such receipts.

Paragraph 6 provides that, notwithstanding the provisions of paragraphs 1 through 5, the benefits of this Convention shall not be allowed to any person that is entitled to income tax benefits under the provisions of the legislation and other measures relating to the tax-free zones (zonas francas) of Madeira and Santa Maria Island, or to benefits similar to those provided with respect to such tax-free zones that are made available under any legislation or other measure adopted by either Contracting State after the date of signature of this Convention. For example, suppose a Portuguese bank located in Lisbon, whose shares are publicly traded on the Lisbon Stock Exchange, establishes a wholly owned subsidiary in Madeira's International Business Centre. In this case, the bank in Lisbon is entitled to treaty benefits under subparagraph 1(c)(i) of Article 17 (Limitation of Benefits) because there is substantial and regular trading of its shares on a recognized securities exchange. Although its wholly-owned Madeira subsidiary passes the requirements for benefits laid out in subparagraph 1(c)(ii) of Article 17, the Madeira subsidiary is not entitled to benefits under the Convention because it is entitled to the benefits available to financial institutions located in Madeira's International Business Center, and paragraph 6 of Article 17 applies "notwithstanding the provisions of paragraphs 1 through 5."

Paragraph 6 further provides that the competent authorities shall notify each other of any future legislation or measure providing benefits similar to those of the tax-free zones of

Madeira and Santa Maria Island and shall consult as to whether such benefits are similar.

In order to implement paragraph 6 appropriately, it is essential that both countries be able to exchange relevant information to distinguish operations in these tax-free zones from other operations in Portugal or the United States that are entitled to the benefits of this Convention. In this connection, see the discussion of Article 28 (Exchange of Information), below.

Article 18. DIRECTORS' FEES

This Article provides that a Contracting State may tax the fees paid by a company that is a resident of that State for services performed by a resident of the other Contracting State in his capacity as a director of the company, provided that the services are performed outside of that other Contracting State. This rule is an exception to the more general rules of Article 15 (Independent Personal Services) and Article 16 (Dependent Personal Services). Thus, for example, in determining whether an outside (non-employee) director's fee is subject to tax in the State of residence of the company, whether the company constitutes a fixed base of the director in that State is not relevant.

The rule provided in this Article represents a departure from the former U.S. Model, which treated a corporate director in the same manner as any other individual performing personal services--outside directors would be subject to the provisions of Article 15 (Independent Personal Services) and inside directors would be subject to the provisions of Article 16 (Dependent Personal Services). The preferred Portuguese position is reflected in the OECD Model, in which a resident of one Contracting State who is a director of a company resident in the other Contracting State is subject to tax in that other State in respect of his directors' fees regardless of where the services are performed. The provision in Article 18 of the Convention represents a compromise between these two positions. The State of residence of the company may tax nonresident directors with no threshold, but only with respect to remuneration for services performed outside the other Contracting State.

This Article is subject to the "saving clause" of subparagraph 1(b) of the Protocol. Thus, if a U.S. citizen who is a Portuguese resident is a director of a U.S. corporation, the United States may tax his full remuneration regardless of the place of performance of his services.

Article 19. ARTISTES AND SPORTSMEN

Article 19 addresses the taxation in a Contracting State of artistes (i.e., performing artists and entertainers) and sportsmen resident in the other Contracting State from the performance of their services as such. The Article applies both to the income of an entertainer or sportsman who performs services on his own behalf and to that of one who performs his services on behalf of another person, either as an employee of that person or pursuant to any other arrangement. This Article applies, however, only with respect to the income of performing artists and sportsmen. Others involved in a performance or athletic event, such as producers, technicians, managers, and coaches, remain subject to the provisions of Article 15 or 16, as the case may be.

Paragraph 1 describes the circumstances in which a Contracting State may tax the performance income of an entertainer or sportsman who is a resident of the other Contracting State. Income derived by a resident of a Contracting State from his personal activities as an entertainer or sportsman exercised in the other Contracting State may be taxed in that other State if the amount of the compensation derived by the individual exceeds $10,000 (or its equivalent in Portuguese escudos) for the taxable year concerned. The $10,000 includes expenses reimbursed to the individual or borne on his behalf. If the compensation exceeds $10,000, the full amount, not just the excess, may be taxed in the State of performance.

The OECD Model provides for taxation by the country of performance of the remuneration of entertainers with no dollar or time threshold. The United States introduces the dollar threshold test to distinguish between two groups of entertainers and sportsmen--those who are paid large sums of money for short periods of service (and who would, therefore, normally be exempt from host country tax under the standard personal services income rules) and those who earn modest amounts (and are, therefore, not clearly distinguishable from those who earn other types of personal service income).

Paragraph 1 applies notwithstanding the provisions of Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services). Thus, if an individual would otherwise be exempt from tax under those Articles, but is subject to tax under this Article, he may be taxed. An entertainer or sportsman who receives less than the $10,000 threshold amount, and who is, therefore, not affected by this Article, may nevertheless be subject to tax in the host country under Article 15 or 16 if the tests for taxability under those Articles are met. For example, if an entertainer who is an independent contractor earns only $9,000 of income for the calendar year, but the income is attributable to a fixed base regularly available to him in the

State of performance, that State may tax his income under Article 15.

Paragraph 2 is intended to deal with the potential for abuse when income from a performance by an entertainer or sportsman does not accrue to the performer himself, but to another person. When the income accrues to a person other than the performer, and the performer (or persons related to him) participate, directly or indirectly, in the profits of that other person, the income may be taxed in the Contracting State where the performer's services are exercised, without regard to the provisions of the Convention concerning business profits (Article 7) or independent personal services (Article 15). Thus, even if the "employer" has no permanent establishment or fixed base in the host country, its income may be subject to tax there under the provisions of paragraph 2. Taxation under paragraph 2 is on the person providing the services of the entertainer or sportsman. This paragraph does not affect the rules of paragraph 1, which apply to the entertainer or sportsman himself. The income taxable by virtue of paragraph 2 to the person providing the performer's services is reduced to the extent of salary payments to the performer, which are treated under paragraph 1.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the entertainer or sportsman) if that other person has control over, or the right to receive, gross income in respect of the services of the entertainer or sportsman. Direct or indirect participation in the profits of a person may include, but is not limited to, the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income, or other income or distributions.

The paragraph 2 override of the protection of Articles 7 (Business Profits) and 15 (Independent Personal Services) does not apply if it is established that neither the entertainer or sportsman, nor any persons related to him, participate directly or indirectly in the profits of the person providing his services. This exception for non-abusive cases to the paragraph 2 override of the Articles 7 and 15 protection of persons providing the services of entertainers and sportsman is not found in the OECD Model.

Paragraph 3 provides an exception to the rules in paragraphs 1 and 2 in the case of a visit to a Contracting State by an entertainer or sportsman who is a resident of the other Contracting State, if the visit is substantially supported, directly or indirectly, by the public funds of his State of residence or of a political subdivision or local authority of that State. In the circumstances described, only the Contracting State of residence of the entertainer or sportsman may tax his income from the performances. A similar exception is provided in some other recent U.S. treaties.

This Article is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol. Thus, if an entertainer or sportsman who is a resident of Portugal is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this Article, subject, however, to the special foreign tax credit provisions of paragraph 2 of Article 25 (Relief from Double Taxation).

Article 20. PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

Article 20 provides rules concerning the taxation of pensions, social security payments, annuities, alimony, and child support. However, the taxation of pensions in respect of governmental services rendered to a Contracting State is covered by the provisions of Article 21 (Governmental Service).

Paragraph 1(a) grants each Contracting State an exclusive taxing right with respect to pensions and other similar remuneration paid to its residents in consideration of past employment, regardless of where the past employment occurred. Paragraph 1(b) provides that social security payments and other public pensions paid to a resident of a Contracting State or a citizen of the United States by the other Contracting State may be taxed in that other State. This rule includes railroad retirement benefits provided for in the Railroad Retirement Act of 1974. Social security payments may be taxable in both Contracting States, with the State of the recipient's residence allowing relief from double taxation under the provisions of Article 25 (Relief from Double Taxation) for any taxes imposed by the Contracting State in which such payments arise.

Paragraph 2 grants an exclusive taxing right with respect to annuities beneficially derived by a resident of a Contracting State. The term "annuities" is defined to mean a stated sum paid periodically at stated times during a specified time period, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered). Payments for services rendered are either employment income or income from the performance of independent personal services.

Paragraph 3 provides that alimony paid to a resident of a Contracting State is taxable only in that State and only to the extent that it is taxable under the domestic law of that State. The term "alimony" is broadly defined and intended to include all periodic payments legally required to be paid as a result of a divorce or separation (other than child support payments). Thus, if a divorced United States resident receives alimony payments from a former spouse resident in Portugal, Portugal may not impose tax on those payments. However, such payments are taxable to the recipient under U.S. domestic law.

Paragraph 4 provides that child support payments made by a resident of one Contracting State to a resident of the other Contracting State may not be taxed by the other Contracting State. As with alimony, child support payments are broadly defined and are intended to include all periodic payments legally required to be paid for the support of minor children as a result of divorce or separation. By prohibiting the State of residence of the recipient from taxing such payments, the Convention ensures that the full amount received is available for the support of the minor children.

With the exception of paragraph 4, Article 20 is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol, so that, in general, the United States may tax its citizens and residents on pensions, annuities, and alimony without regard to any restriction in Article 20. However, by virtue of paragraph 1(c) of the Protocol, paragraph 4 of Article 20 is not subject to the saving clause. Thus, domestic law cannot overrule the exemption provided for in paragraph 4 from tax for child support payments.

Article 21. GOVERNMENT SERVICE

Article 21 applies to remuneration paid by a Contracting State (or political subdivision or local authority thereof) in respect of services rendered to that State (or political subdivision or local authority). Paragraph 1 applies to remuneration, other than pensions, for governmental service, and paragraph 2 applies to pensions arising from such governmental service.

Paragraph 1(a) grants an exclusive taxing right for remuneration in respect of governmental service to the Contracting State (or political subdivision or local authority thereof) to which such services are rendered, regardless of who renders such services or where such services are rendered.

Paragraph 1(b) provides an exception to paragraph 1(a). It grants an exclusive taxing right for remuneration for governmental services to the State in which such services are rendered, provided that the recipient is a resident of that State and is either a national of that State or did not become a resident solely for the purpose of rendering the services. Thus, if a Portuguese resident renders services to the U.S. Government in Portugal, Portugal is granted the exclusive right to tax such services if the recipient is either a Portuguese national or did not become a Portuguese resident solely for the purpose of providing such services.

Paragraph 2(a) grants an exclusive taxing right for any pension paid in consideration for past governmental services to the Contracting State (or political subdivision or local authority thereof) to which such services were rendered. Paragraph 2(b) provides an exception to paragraph 2(a) and grants an exclusive taxing right for such pensions to the other Contracting State if the recipient is both a resident and a national thereof. Thus, the United States is granted the exclusive right to tax a U.S. national who retires to Portugal and receives a pension resulting from services rendered to the U.S. Government.

Under paragraph 3, payments for (and subsequent pensions arising from) services that are rendered in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof are, as appropriate, dealt with under Article 15 (Independent Personal Services), 16 (Dependent Personal Services), 18 (Directors' Fees), 19 (Artistes and Sportsmen), or 20 (Pensions, Annuities, Alimony, and Child Support). It is understood that determinations of whether remuneration is for services (1) rendered to a Contracting State (or political subdivision or local authority thereof) or (2) rendered in connection with a business carried on by a governmental agency or authority is to be made by reference to the laws of the State in which the income arises.

Article 21 is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol, as modified by subparagraph 1(c) of the Protocol. With respect to the United States, the modified saving clause applies to U.S. citizens and persons having immigrant status in the United States ("green card" holders). Thus, the provisions of the Article that would grant exclusive taxing rights to Portugal are overridden by the saving clause if the individuals are U.S. citizens or green card holders.

Article 22. TEACHERS AND RESEARCHERS

Paragraph 1 of the Article deals with visiting professors, teachers, and researchers. Paragraph 1 provides that if a professor, teacher, or researcher who is a resident of one Contracting State visits the other Contracting State for the purpose of teaching or conducting research at an accredited educational or research institution, he will be exempt from tax in both Contracting States on his compensation for such teaching or research for a period not exceeding two years. An individual may claim the benefits of paragraph 1 only once.

For the exemption of paragraph 1 to apply to income from research, the research must be undertaken in the public interest, and not primarily for the private benefit of a specific person or persons. For example, the exemption would not apply to a grant from a tax-exempt research organization to search for the cure to a disease if the results of the research become the property of a for-profit company. The exemption would not be denied, however, if the tax-exempt organization licensed the results of the research to a for-profit enterprise in consideration of an arm's length royalty consistent with its tax-exempt status.

This Article is an exception to the "saving clause" of subparagraph 1(b) of the Protocol. Thus, a Portuguese student, teacher, or researcher is entitled to the benefits of this Article even if such individual becomes a resident of the United States under the "substantial presence" test of Code section 7701(b). The benefits of this Article are not available to a U.S. citizen or "green card" holder for U.S. tax purposes. However, Code section 911 generally exempts the first $70,000 of foreign earned income of a U.S. citizen or resident who spends a specified period of time in one or more foreign countries.

ARTICLE 23. STUDENTS AND TRAINEES

Paragraph 1 of Article 23 provides that a resident of a Contracting State who visits the other Contracting State for the primary purpose of studying at an accredited educational institution, securing training in a professional specialty, or studying or doing research as a recipient of a grant from a tax-exempt organization shall be exempt from taxation in that Contracting State with respect to certain items of income during such period of study, research, or training. Paragraph 1(b) defines those exempt items of income as: (1) payments from abroad for maintenance, education, study, research, or training; (2) grants, allowances, or awards from a governmental, religious, charitable, scientific, literary, or educational institution funding the research or studies; and (3) income from personal services performed in that other Contracting State to the extent of $5,000 (or the equivalent in Portuguese escudos) per taxable year. The exemptions provided in paragraph 1 are available to the visiting student or trainee for a period not exceeding five years from the beginning of the visit.

The second paragraph of the Article provides an exemption for residents of a Contracting State who are employed by, or under contract with, a resident of the same Contracting State and who temporarily visit the other Contracting State for the purpose of studying at an accredited educational institution or acquiring technical, professional, or business training or experience in that other Contracting State, provided such training is from a person other than the employer or contractor. Such student or trainee is exempt from taxation in the other Contracting State for a period of twelve consecutive months on personal services income to the extent of $8,000 (or the equivalent in Portuguese escudos) during that period.

The Article denies its exemptions, as does paragraph 2 of Article 22 (Teachers and Researchers), to income from research if such research is undertaken primarily for the private benefit of a specific person or persons. For example, personal service income arising from research at a corporate research facility would, in general, not qualify as exempt income.

The benefits conferred by the other Contracting State under Article 23 are subject to the provisions of the "saving clause" in subparagraph 1(b) of the Protocol, as modified by subparagraph 1(c) of the Protocol. With respect to the United States, the modified saving clause applies to U.S. citizens and persons having immigrant status in the United States ("green card" holders). Thus, the provisions of paragraph 1 that would exempt a Portuguese resident from taxation as a student in the United States are overridden by the saving clause if that student is a U.S. citizen or green card holder. On the other hand, if a student who is not a citizen or a green card holder acquires residence in the United States for tax purposes during that period of study or training, he will be exempt from tax in the United States on those items of income.

ARTICLE 24. OTHER INCOME

Paragraph 1 of Article 24 provides for exclusive residence State taxation of items of income that are not dealt with in the foregoing Articles of the Convention, unless the income arises in the other Contracting State. If the income arises in the other State, that other State may also tax it. This rule applies, for example, to prizes, awards, or gifts, and to income from third States.

Paragraph 2 provides that, if the beneficial owner of such other income carries on business in the other Contracting State through a permanent establishment or fixed base situated therein and the income is attributable to such permanent establishment or fixed base, that other income is taxable in that other State in accordance with the provisions of Article 7 (Business Profits) or 15 (Independent Personal Services), rather than under the provisions of paragraph 1. Thus, for example, income of a U.S. resident that arises in a third country but is attributable to a permanent establishment of such person in Portugal may be taxed by Portugal under the provisions of Article 7.

However, paragraph 2 does not provide an exception to the exclusive taxing right granted in paragraph 1 to the state of residence with respect to income from real property. Thus, for example, income derived from real property located in a third country is taxable under this Convention only in the Contracting State of which the recipient (beneficial owner) is a resident, even if the recipient has a permanent establishment (or fixed base) in the other Contracting State and that real property forms part of the business property of that permanent establishment or fixed base.

Article 24 is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol so that, in general, the United States may tax "other income" of U.S. residents and citizens without regard to the Convention. Specifically, this means that, irrespective of the exclusive right to tax third country income granted to the state of residence in paragraph 1, the United States also may tax such income received by a resident of Portugal if that resident is a U.S. citizen, subject, however, to the special foreign tax credit provisions of paragraph 2 of Article 25 (Relief from Double Taxation).

Article 25. RELIEF FROM DOUBLE TAXATION

In this Article, each Contracting State undertakes to relieve double taxation by granting a foreign tax credit against its income tax for the income tax paid to the other country. Under paragraph 1, the credit granted by the United States is allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of this Article (the allowance of a credit) is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions of the U.S. domestic law in effect for the taxable year concerned.

The U.S. foreign tax credit is generally limited under the Code to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a)). However, nothing in the Convention would prevent the limitation of the U.S. credit from being applied on a per-country or overall basis or some variation thereof, if U.S. domestic law so provided. In general, where source rules are provided in the Convention for purposes of determining the taxing rights of the Contracting States, these are consistent with the Code source rules for foreign tax credit and other purposes. Where, however, there is an inconsistency between Convention and Code source rules, the Code source rules (e.g., Code section 904(g)) will be used to determine the limits for the allowance of a credit under the Convention.

Paragraph 2 provides an exception to the general rule of paragraph 1 for the tax treatment of U.S. citizens resident in Portugal. Under this paragraph, income that may be taxed by the United States solely by reason of citizenship in accordance with the "saving clause" of subparagraph 1(b) of the Protocol shall be treated as having its source in Portugal to the extent necessary to avoid double taxation. This provision overrides U.S. law source rules only in those cases where U.S. law would operate to deny a foreign tax credit for taxes imposed by Portugal under the provisions of the Convention on U.S. citizens resident in Portugal. In no case, however, will this provision apply to reduce the taxes paid to the United States below the amount that would be paid if the individual were not a citizen of the United States, i.e., the U.S. tax that would be imposed if the individual were not a resident or citizen of the United States.

As an example of the application of paragraph 2, consider a U.S. citizen resident in Portugal who receives $200 of portfolio dividend income from United States sources and is subject to U.S. tax at 28 percent ($56) on that income. Under the provisions of Article 10 (Dividends), the U.S. tax on portfolio dividends paid to residents of Portugal who are not U.S. citizens is limited to 15 percent ($30 in this case). Suppose Portugal taxes that income of its resident at 40 percent ($80) and grants, in accordance with the provisions of its domestic law and paragraph 2 of this Article, a credit for the $30 of U.S. tax imposed on the basis of source only. The net Portuguese tax would be $50 and the combined U.S. and Portuguese tax $106. Thus, the total tax would be higher than the total tax in either of the two countries, indicating some double taxation. Under paragraph 2, the United States agrees to resource enough of that dividend income to avoid double taxation, but not to reduce the U.S. tax paid below the $30 it is entitled to tax at source. In this example, the U.S. will resource enough of the dividend to permit a credit of $26, thus reducing its net tax from $56 to $30. The total tax becomes $80 ($50 + 30), the higher of the two taxes, and double taxation is eliminated.

By reason of subparagraph 1(c)(i) of the Protocol, Article 25 is not subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol. Thus, the saving clause cannot be used to deny a Portuguese resident the benefit of the credits provided for in paragraph 1 or to deny a U.S. citizen or resident the benefit of the credits provided for in paragraphs 2 and 3.

Subparagraph 2(a) provides that Portugal shall provide a "deduction from tax," i.e., a credit, for taxes paid to the United States by a Portuguese resident. The credit is limited, however, to the amount of income tax that would otherwise be owed to Portugal on the income that may be taxed in the United States.

Portuguese domestic law does not give a credit similar to the U.S. credit for taxes deemed paid under Code section 902. However, subparagraph 3(b) provides the same 95-percent dividends received deduction for dividends received by a Portuguese company from a U.S. company that Portugal provides domestically for dividends received by a Portuguese company from another Portuguese company. As a practical matter, this eliminates double taxation of such profits.

Subparagraph 3(c) provides that where, in accordance with any provision of the Convention, income derived by a resident of Portugal is exempt from tax in Portugal, Portugal may, nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income. The portion of tax forgiven is thus calculated at the average tax rate, not at either the top or bottom bracket rate.

Article 26. NON-DISCRIMINATION

This Article prohibits the discriminatory taxation by one Contracting State of nationals, enterprises, and residents of the other Contracting State.

Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or any connected requirement in the other Contracting State that is different from or more burdensome than the taxation and connected requirements imposed upon a national of that other State in the same circumstances. A national of a Contracting State is afforded protection under this paragraph even if the national is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same treatment in Portugal as a Portuguese national who is in similar circumstances. It is understood, however, that for U.S. tax purposes, a U.S. citizen who is resident outside the United States, whether in Portugal or a third country, is not in the same circumstances as a national of Portugal who is a resident outside the United States, because the U.S. citizen is subject to U.S. tax on his worldwide income while the Portuguese national is subject to U.S. tax only on U.S. source income and limited types of foreign source income.

Paragraph 2 of the Article provides that a permanent establishment in a Contracting State of a resident of the other Contracting State may not be less favorably taxed in the first State than an enterprise of that first State that is carrying on the same activities. This provision, however, does not oblige a Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, or deductions that it grants to its own residents on account of their civil status or family responsibilities. Thus, in assessing income tax on the profits attributable to a U.S. permanent establishment of a Portuguese enterprise owned by an individual resident in Portugal, the United States is not obligated to allow to the Portuguese resident the personal allowances for himself and his family that would be allowed if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident.

Section 1446 of the Code imposes on any partnership with income effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to a Portuguese resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. However, it is understood that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article, but like other withholding on nonresident aliens, is a reasonable method for the collection of tax from persons who are not continually present in the United States and as to whom it may otherwise be difficult for the United States to enforce its tax jurisdiction. If tax is over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 3 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch tax described in paragraph 1 of Article 12 (Branch Tax).

Paragraph 4 prohibits discrimination in the allowance of deductions. When a resident of a Contracting State pays interest or royalties or makes other disbursements to a resident of the other Contracting State, the first Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 6 of Article 13 (Royalties) apply, because all of these provisions permit the denial of deductions in certain circumstances in respect to excessive (non-arm's length) payments between related persons. The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense.

Paragraph 5 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company that is a resident of that State and that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the requirements that it imposes on similar resident companies owned by residents of the first State. The rules of Code section 367(e)(2) regarding liquidating distributions of appreciated property by a U.S. subsidiary to a foreign parent corporation, the provision in Code section 1446 for withholding of tax on distributions to non-U.S. partners (discussed above), and the rule of Code section 1361 under which nonresident alien individuals are ineligible to become shareholders of subchapter S corporations, do not violate the provisions of this Article.

Paragraph 6 provides that, notwithstanding the list of taxes covered by the Convention in Article 2 (Taxes Covered), the nondiscrimination provisions of this Article apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. Customs duties are not considered to be taxes for this purpose.

The "saving clause" of subparagraph 1(b) of the Protocol does not apply to this Article, by virtue of the exceptions in subparagraph 1(c) of the Protocol. Thus, for example, a U.S. citizen who is resident in Portugal may claim U.S. benefits under this Article.

Article 27. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. The competent authorities of the two Contracting States are identified in subparagraph 1(i) of Article 3 (General Definitions).

Paragraph 1 provides that, where a person considers that the actions of one or both Contracting States result or will result for him in taxation that is not in accordance with the Convention, he may present his case to the competent authority of his State of residence or citizenship. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the Convention. It is not necessary for a person first to have fully exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit, and if it cannot reach a satisfactory solution unilaterally, it will seek agreement with the competent authority of the other Contracting State to avoid taxation not in accordance with the Convention. Any agreement reached under this provision is to be implemented even if implementation would be otherwise barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Because, as specified in subparagraph 1(a)(i) of the Protocol, the Convention cannot operate to increase a taxpayer's liability, time or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.

Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. It is intended that the competent authorities may agree, for example, to the same attribution of income, deductions, credits, or allowances between a resident of one Contracting State and its permanent establishment in the other; to the allocation of income, deductions, credits, or allowances between persons; or to settle a variety of interpretive issues under the Convention, including those regarding the characterization of items of income or of persons, the application of source rules to particular items of income, the meaning of a term, and the application of penalties, fines and interest. Agreements reached by the competent authorities under this paragraph need not conform to the domestic law provisions of either Contracting State.

Paragraph 3 also authorizes the competent authorities to address double taxation in cases not provided for in the Convention, with respect to types of taxes covered by the Convention. An example might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third-country resident, one in the United States and the other in Portugal. Since no resident of a Contracting State is involved in the case, the Convention does not, by its terms, apply. The competent authorities may, nevertheless, use the authority of the Convention to seek to prevent double taxation.

Paragraph 4 authorizes the competent authorities to communicate with each other directly, rather than through diplomatic channels, for these purposes.

The benefits of this Article are also available to residents or citizens of either Contracting State under subparagraph 1(c)(i) of the Protocol. Thus, rules, definitions, procedures, and other matters that are agreed upon by the competent authorities under this Article may be applied by the United States with respect to its citizens and residents, even if those agreements differ from the comparable Code provisions. Similarly, U.S. law may be overridden to provide refunds of tax to a U.S. citizen or resident under this Article.

Article 28. EXCHANGE OF INFORMATION

This Article provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that necessary for carrying out the provisions of the Convention or the domestic laws of the United States or Portugal concerning the taxes covered by the Convention. For purposes of this Article, the taxes covered by the Convention include all taxes imposed at the national level. Exchange of information with respect to domestic law is authorized insofar as the taxation under those domestic laws is not contrary to the Convention. Thus, for example, information may be exchanged with respect to a national-level tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State.

Paragraph 1 states that information exchange is not restricted by Article 1 (Personal Scope). This means that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Portugal that engages in transactions with a U.S. resident, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Such information would not be routinely exchanged, but may be requested in specific cases.

Paragraph 1 also provides assurances that any information received in accordance with this Article will be treated as secret, subject to the same disclosure constraints that apply to information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, enforcement, or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. The information must be used by such persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received under this Article may be disclosed in public court proceedings or in judicial decisions.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either Contracting State. Nor is a State obligated to supply information not obtainable under the laws or administrative practice of either State. Thus, there is no obligation to furnish information if either the requested State or the requesting State could not obtain such information for itself in a domestic case. There is also no obligation to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. However, it is understood that bank records will be made available to the same extent obtainable for enforcing domestic tax laws, including requests for court orders where the taxpayer does not voluntarily comply. Paragraph 14 of the Protocol confirms that records of financial institutions, including records relating to third parties, are among the types of records that may be exchanged.

A Contracting State may, at its discretion, subject to the limitations of paragraph 2 and its domestic law, provide information that it is not obligated to provide under the provisions of this paragraph.

Paragraph 3 provides that, when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no tax interest in the case to which the request relates. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g., depositions of witnesses and authenticated copies of unedited original documents), so that the information can be used in the judicial proceedings of the requesting State. The requested State must provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

This Article is particularly important for implementing paragraph 6 of Article 17 (Limitation of Benefits), the provision that denies benefits under the Convention to persons entitled to the benefits of tax-free zones. Since the tax-free zones of Madeira and Santa Maria Island are within the Portuguese Republic, it is essential that the United States be able to obtain the information necessary to distinguish between income associated with entities that are entitled to treaty benefits and income associated with entities that are not entitled to treaty benefits. In this regard, it is often particularly difficult to make such distinctions for financial institutions. Portugal has assured the United States that it will use the same measures in responding to U.S. requests that it is able to use for its own internal purposes. This commitment extends to requests to Portuguese courts, if necessary, that a bank be compelled to provide requested information. Information supplied by Portugal suggests that when the Portuguese authorities ask their courts to obtain necessary information from Portuguese taxpayers, the courts provide timely, positive responses.

Article 29. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article confirms that any fiscal privileges to which members of diplomatic or consular missions are entitled under the general provisions of international law or under special agreements will apply, notwithstanding any provisions of this Convention to the contrary. This provision also applies to residents of either Contracting State, provided that they are not citizens of that State and, in the case of the United States, are not "green card" holders. (See subparagraph 1(c)(ii) of the Protocol.)

Article 30. ENTRY INTO FORCE

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides that the Convention is subject to ratification by each

Contracting State, and that the instruments of ratification shall be exchanged as soon as possible.

Paragraph 2 provides that the Convention will enter into force on the date on which instruments of ratification are exchanged. Subparagraph 2(a) provides that the Convention will have effect with respect to taxes withheld at source for amounts paid or credited on or after the first day of January following the date of entry into force. For example, if the Convention were to enter into force on July 1, 1995, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after January 1, 1996. For all other taxes, the Convention will have effect for any taxable year beginning on or after January 1 of the year following the year in which the Convention enters into force, (in this example, January 1, 1996).

Article 31. TERMINATION

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of this Article. The Convention may be terminated at any time after five years from the date of its entry into force, provided that written notice has been given through diplomatic channels at least six months in advance. If such notice is given, the Convention will cease to apply in respect of taxes withheld on dividends, interest, and royalties paid or credited on or after the first day of the January following the expiration of the six-month period. The Convention will cease to apply with respect to other taxes for taxable periods beginning on or after the first day of January following expiration of the six-month period. Thus, for example, if notice of termination is given in July or later of a calendar year, the termination will not be effective as of the following January 1 but as of the second January 1 thereafter, since the notice period must last at least six months.