[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE FRENCH REPUBLIC

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON MAY 25, 1995

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty between the United States and the French Republic ("France"). The proposed treaty was signed on August 31, 1994, and amplified by diplomatic notes signed the same day. The proposed treaty would replace the existing income tax treaty between the two countries that was signed in 1967 and modified by protocols signed in 1970, 1978, 1984, and 1988. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on May 25, 1995.

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

Part I of the pamphlet summarizes the principal provisions of the proposed treaty. Part II presents a discussion of issues that the proposed treaty presents. Part III provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. For a copy of the proposed treaty, see Senate Treaty Doc. 103-32, September 19, 1994. For a detailed, article-by-article explanation of the proposed treaty, see the "Treasury Department Technical Explanation of the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Signed at Paris on August 31, 1994," May 1995 (hereinafter "Technical Explanation").

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the French Republic* (JCS-10-95), May 22, 1995.

[2] The U.S. model has been withdrawn from use as a model treaty by the Treasury Department. Accordingly, its provisions may no longer represent the preferred position of U.S. tax treaty negotiations.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

I. SUMMARY

In general

The principal purposes of the proposed income tax treaty between the United States and France are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to continue to promote close economic cooperation and facilitate trade and investment between the two countries. It is also intended to enable the countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are achieved principally by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty provides that a treaty country would not tax business income derived from sources within that country by residents of the other country unless the business activities in the first country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country would not be required to pay tax in that other country unless their contact with that country exceeds specified minimums (Articles 14-17). The proposed treaty provides that dividends, royalties, and certain gains derived by a resident of either country from sources within the other country generally would be taxable by both countries (Articles 10, 12 and 13). Generally, however, dividends and royalties received by a resident of one country from sources within the other country would be taxed by the source country on a restricted basis or not at all (Articles 10 and 12). The proposed treaty provides that as a general rule, the source country could not tax interest received by a resident of the other treaty country (Article 11).

In situations where the country of source would retain the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally would provide for the relief of the potential double taxation generally by requiring the other country either to grant a credit against its tax for the taxes paid to the source country or to exempt that income from its tax (Article 24).

The proposed treaty contains a "saving clause" similar to that contained in other U.S. tax treaties (Article 29(2)). Under this provision, the United States generally would retain the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the proposed treaty contains the standard provision that it would not apply to deny a taxpayer any benefits that person is entitled to under the domestic law of the country or under any other agreement between the two countries (Article 29(1)); that is, the treaty would only apply to the benefit of taxpayers.

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

Summary of treaty provisions

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

(1) The proposed treaty generally applies only to residents of the United States and to residents of France (Article 1). This follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. Unlike most other U.S. income tax treaties and the model treaties, however, the nondiscrimination rules of the proposed treaty do not apply to citizens or nationals of a treaty country who are not residents of that treaty country (Article 25). Thus, for example, the proposed treaty would offer no protection for a U.S. citizen resident in a third country in the unlikely event that France would impose discriminatory taxation on residents of that country.

(2) Unlike the U.S. model and many U.S. income tax treaties in force, but like the present treaty, the proposed treaty does not affect the imposition by the United States of the accumulated earnings tax and the personal holding company tax. In addition, like the U.S. model, the proposed treaty applies to the excise taxes imposed with respect to the investment income of private foundations and, subject to an "anti-conduit rule," to the U.S. excise tax imposed on insurance premiums paid to foreign insurers (Article 2).

(3) The definition of the term "United States" as contained in Article 3 of the proposed treaty generally conforms to the definition provided in the U.S. model. In both treaties the term generally is limited to the United States of America, thus excluding from the definition U.S. possessions and territories. The proposed treaty, however, makes it clear that the United States includes its territorial sea and the seabed and subsoil of the adjacent area over which the United States may exercise rights in accordance with international law and in which laws relating to U.S. tax are in force. The U.S. model is silent with respect to this point. The definition of the term "France" as contained in the proposed treaty similarly includes its territorial sea and the seabed and subsoil of the adjacent area.

(4) A U.S. citizen who is not also a U.S. resident (i.e., he or she does not have a substantial presence, permanent home, or habitual abode in the United States) generally would not be covered by the proposed treaty (Article 4).[3] The U.S. model does cover such U.S. citizens. The United States rarely has been able to negotiate coverage for nonresident citizens, however.

(5) For purposes of qualifying for benefits under the proposed treaty, the term "resident of a Contracting State" specifically includes the governments of the two treaty countries, including their political subdivisions and local authorities, and any agencies or instrumentalities of those national or subnational governmental bodies. The term also covers a pension trust and any other organization established in the treaty country and maintained exclusively

[3] Similarly, the treaty would not cover an alien who has been admitted for permanent U.S. residence (i.e., a "green card" holder) unless that person has a U.S. substantial presence, permanent home, or habitual abode.

to administer or provide retirement or employee benefits that is established or sponsored by a person that is a treaty-country resident, and any not-for-profit organization established and maintained in the treaty country, provided that applicable local laws limit the use of the organization's assets, 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.

(6) In the case of income derived or paid by a partnership or similar pass-through entity, estate, or trust, the term "resident of a Contracting State" applies only to the extent that the income derived by such entity is subject to tax in that country as the income of a resident, either in the hands of the entity or in the hands of its partners, beneficiaries, or grantors. In a case where the partnership or other entity is subject to tax by a treaty country at the entity level, it would be treated as a resident of that country under the treaty. The proposed treaty specifies that a *société de personnes, a groupement d'intérêt économique* (economic interest group), or a *groupement européen d'intérêt économique* (European economic interest group) that is constituted in France and has its place of effective management in France and that is not subject to French company tax would be treated as a partnership for purposes of U.S. tax benefits under the proposed treaty, and, as specified in diplomatic notes, for purposes of U.S. tax benefits under any other U.S. tax treaty.

(7) The definition of a permanent establishment in Article 5 of the proposed treaty follows the corresponding provision in the U.S. model.

(8) The proposed treaty includes the usual provision assigning the primary right to tax income from real property to the situs country. However, unlike the U.S. model treaty and most U.S. treaties, but like the OECD model treaty and several recent U.S. treaties, Article 6 of the proposed treaty defines real property to include accessory property, as well as livestock and equipment used in agriculture and forestry.

(9) Unlike the U.S. and OECD model treaties and most other U.S. treaties, Article 6(5) of the proposed treaty provides a special rule that allows the situs country to tax corporate shareholders on the imputed rental value of real property owned by the corporation that they, as shareholders, are entitled to use. Like the present treaty, however, the proposed treaty precludes income taxation on the basis of the imputed rental value of housing owned in the taxing country by an individual resident of the other treaty country (Article 29(5)). Only France currently imposes tax on such a basis.

(10) Article 7 of the proposed treaty provides that business profits attributable to a permanent establishment in one treaty country may be taxed by that country even if the payments are deferred until after the permanent establishment has ceased to exist. This clarifies that Code section 864(c)(6) would not be overridden by the proposed treaty.

(11) Both the proposed treaty and the U.S. model treaty contain definitions of the term "business profits." Under the U.S. model definition (as well as under the definition contained in many other U.S. income tax treaties), business profits include income from the

rental of tangible personal property and from the rental or licensing of films and tapes. Thus, such rental income earned by a resident of one treaty country from sources in the other country would only be taxable in the source country if the income is attributable to a permanent establishment or fixed base of that taxpayer in that country. The proposed treaty, consistent with the OECD model treaty, treats payments for the rental or licensing of films and tapes as royalties, which generally are exempt from tax in the source country (under Article 12) unless they are attributable to a permanent establishment. Thus, though the language of the proposed treaty is different from that of the present treaty and the U.S. model treaty, the treatment of rental or licensing payments with respect to films and tapes is the same.

(12) The proposed treaty, like the present treaty but unlike the U.S. model, provides that partners would be treated as realizing income and incurring losses in accordance with their shares of the partnership's profits and losses, taking into account any special allocations that have substantial economic effect. This rule, consistent with U.S. law, would also apply to France.

(13) Like the present treaty and some other existing U.S. income tax treaties, Article 8 of the proposed treaty does not provide protection from source country taxation of income from leases of containers used in international traffic to the same extent as the U.S. model treaty, which exempts such income from source country tax as income from the operation of ships or aircraft in international traffic. For example, the model provides for exemption from tax in the source country for a container lessor (such as a financial institution or a leasing company) that does not also operate ships or aircraft in international traffic, but that leases containers to others for use in international traffic. Under the proposed treaty, the exemption for shipping profits does not apply to profits from container leasing unless those leasing activities are "accessory" or incidental to international shipping activities of the lessor. Such profits are treated as business profits under the proposed treaty, and thus exempt from tax in the source country unless attributable to a permanent establishment in that country.[4]

(14) Similar to the OECD model treaty, the article on associated enterprises (Article 9) of the proposed treaty omits the provision found in the U.S. model treaty and in most other U.S. treaties which clarifies that neither treaty country is precluded from (or limited in) the use of any domestic law which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of one of the treaty countries, owned or controlled directly or indirectly by the same interests, where necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons. However, the Technical Explanation states that the omitted language serves merely as a clarification, and that the proposed treaty is intended to fully preserve the rights of each country to apply its internal laws relating to adjustments between related parties.

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[4] The OECD published a view that containers should be treated as they are in the proposed treaty. OECD Committee on Fiscal Affairs, *The Taxation of Income Derived From the Leasing of Containers* para. 15 (1985).

(15) Under Article 10 of the proposed treaty, as under the U.S. model treaty, direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly (in the case of a French owner of a U.S. payor) or indirectly (in the case of a U.S. owner of a French payor) at least 10 percent of the voting shares of the payor) generally are taxable by the source country at a rate no greater than 5 percent. Other dividends generally are taxable by the source country at a rate no greater than 15 percent. However like recent U.S. treaties, the proposed treaty would apply a withholding tax rate of 15 percent on dividends if those dividends are paid by a U.S. regulated investment company (RIC) or a French *société d'investissement à capital variable (SICAV)*, regardless of whether the RIC or *SICAV* dividends are paid to a direct or portfolio investor. The proposed treaty does not provide for a reduction of U.S. withholding tax on dividends paid by a real estate investment trust (REIT), unless the dividend is beneficially owned by an individual French resident holding a less than 10-percent interest in the REIT.

(16) Generally, the proposed treaty, the U.S. model, and the OECD model all share a common definition of the term "dividends."[5] The proposed treaty further defines this term, however, to include income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the local law on the treaty country in which the income arises. That is, each country would apply its domestic law, for example, in differentiating dividends from interest.

(17) The proposed treaty specifically treats as dividends any payments in lieu of dividends to holders of depository receipts representing beneficial ownership of shares.

(18) The proposed treaty, like the present treaty, allows U.S. shareholders to receive the benefit of all or a portion of the dividend tax credit (*avoir fiscal*) that French resident shareholders receive with respect to dividends from French corporations as part of the imputation tax system employed in France (Article 10(4)). U.S. shareholders generally receive the same *avoir fiscal* that French shareholders receive, subject to a deduction of the applicable dividend withholding tax imposed on the gross amount of the dividend plus the credit. Under French law, the *avoir fiscal* is allowed in the amount of one-half of the net dividend, which is equivalent to the entire corporation tax at the current French rate of 33.33 percent. For example, assume that a French corporation earns Ff300 of taxable income, pays corporate tax of Ff100, and distributes Ff200 to its U.S. portfolio shareholders as a dividend. The amount of the *avoir fiscal* will be half of the dividend, or Ff100. Withholding tax will be imposed at the treaty rate of 15 percent on the full Ff300 of dividend plus *avoir fiscal*. The *avoir fiscal* credit of Ff100 against withholding tax of Ff45 will result in a net refund of French tax to the U.S. shareholders (assuming all of them qualify) of Ff55, in addition to their net cash dividend of Ff200.

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

The full *avoir fiscal* is available under the proposed treaty to a U.S. resident that is an individual, another person that is not a company, a company (other than a RIC) that does not own (directly or indirectly) 10 percent or more of the stock of the payor, or a RIC that does not own (directly or indirectly) 10 percent or more of the stock of the payor but only if non-U.S. persons own less than 20 percent of the RIC's shares.

The *avoir fiscal* is available only to shareholders that are subject to U.S. income taxation of the dividend and the *avoir fiscal* payment. Dividends paid to pass-through entities would be eligible to the extent of the eligibility of their partners or beneficiaries.

A reduced *avoir fiscal*, in the amount of 30/85 of the full amount (less applicable withholding tax), is available under the proposed treaty to certain investments by certain U.S. pension plans (not including plans that own, directly or indirectly, 10 percent or more of the stock of the payor). The reduced *avoir fiscal*, which is not granted by France under the present treaty, would be effective for distributions paid after December 31, 1990.

In the case of dividends paid to U.S. recipients that are not eligible to receive the *avoir fiscal*, the proposed treaty allows a refund of the French corporate tax prepayment (*précompte*) which is imposed with respect to distributions of earning that have not borne full French corporate tax. The *précompte* refund would be treated as a dividend for purposes of the withholding taxes allowed by the proposed treaty. French statutory law imposes the *précompte* on dividends without regard to the qualification of the recipient for the *avoir fiscal*.

(19) The proposed treaty, similar to the present treaty and other U.S. treaties negotiated since 1986, expressly permits imposition of the branch profits tax in certain cases (Article 10(7)). The rate of that tax may not exceed 5 percent.

The United States is allowed under the proposed treaty to impose the branch profits tax on a French corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from real property or gains from the disposition of interests in real property. The tax would be imposed on the "dividend equivalent amount," as defined in the Code. In cases where a French corporation conducts a trade or business in the United States but *not* through a permanent establishment, the proposed treaty would completely eliminate the branch profits tax that the Code would otherwise impose on such corporation (unless the corporation earned income from real property as described above). France is allowed to impose its corresponding tax under *quinquies*, article 115 of the French tax code (*code général des impôts*).

The proposed treaty makes clear that nothing in the non-discrimination article (Article 25) should be construed as preventing either country from imposing its branch profits tax.

(20) Under Article 11 of the proposed treaty, like the present treaty and the U.S. model treaty, interest generally is exempt from source-country taxation. However, interest that is determined by reference to the profits of the issuer (or one of its associated enterprises) would be subject to source-country taxation at a maximum rate of 15 percent. In addition, no exemption or reduction of U.S.

withholding tax would be granted under the proposed treaty to a French resident that is a holder of a residual interest in a U.S. real estate mortgage investment conduit (REMIC) with respect to any excess inclusion.

Interest, for purposes of the proposed treaty, does not include any amount treated as a dividend under Article 10.

(21) The proposed treaty generally exempts from source-country taxation royalties for the use of a copyright (or the use of a neighboring right such as reproduction or performing rights) of literary, artistic, or scientific work, including films, sound or picture recordings, and software (Article 12). However, the proposed treaty allows source-country taxation of certain other types of royalties at a maximum rate of 5 percent. Both the U.S. and OECD model treaties exempt royalties from source-country tax. The category of royalties which would be subject to source-country tax includes payments of any kind received as a consideration for the use of, or the right to use any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience.

(22) Although not found in the OECD model, the U.S. model, or many other U.S. treaties, Article 12(6) of the proposed treaty contains a special provision for determining the source of royalties. The special sourcing provision includes three separate rules. First, if the royalty is paid by a resident of the United States or France, the royalty would be treated as arising in that country. Second, if the royalty is paid by a person, whether or not a resident of the United States or France, that has a permanent establishment or fixed base in one of the countries in connection with which the liability to pay the royalty arose, and if the royalty is actually borne (i.e., is deducted in computing taxable income) by that permanent establishment or fixed base, then the royalty would be deemed to arise in the country in which the permanent establishment or fixed base is located. Third, notwithstanding the first and second rules, a royalty paid for the use of, or the right to use, property in the United States or France would be deemed to arise in that country. The staff understand that this provision would apply both for purposes of determining whether royalties are taxable in the source country, and in determining the source of royalties for purposes of computing the foreign tax credit under the article on relief from double taxation (Article 24). This dual application of the special sourcing provision avoids a potential mis-match between jurisdiction to tax and obligation to relieve double taxation.

By contrast, since the U.S. model does not specifically provide (for any purpose) a sourcing rule for royalties, the applicable rule of domestic law applies. With respect to the domestic law of the United States, royalties generally are sourced in the country where the property giving rise to the royalty is used (Code sec. 861(a)(4)).

(23) Both the U.S. model treaty and the proposed treaty (Article 13) provide for source-country taxation of capital gains from the disposition of property used in the business of a permanent establishment in the source country. Like most recent U.S. tax treaties, the proposed treaty also provides for source-country taxation of such gains where the payments are received after the permanent establishment has ceased to exist. In addition, the proposed treaty

provides that in a case where the laws of one treaty country tax the removal of such property from that country as a deemed disposition of the property, that country is permitted to tax the gain that accrues up to the time of removal, and the other country is permitted to tax the gain that accrues after the time of removal. Treasury's Technical Explanation indicates that such divided tax jurisdiction is exclusive; the residence country is not permitted to tax gain accruing prior to removal, and the source country is not permitted to tax gain accruing subsequent to removal.

Staff understand that this provision represents a combination of the French custom of taxing accrued, but unrealized gains at the time the asset is removed from France, with the U.S. rules that generally permit the United States to tax the realization of gains from the disposition of property that formerly was part of a U.S. business. This rule of the proposed treaty is not subject to the saving clause.[6]

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

(24) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of real property regardless of whether the taxpayer is engaged in a trade or business in the source country. The proposed treaty expands the U.S. model treaty definition of real property for these purposes to encompass U.S. real property interests. This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980, which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations. France is permitted to tax similar real property interests situated in France. Look-through rules apply in the case of real property interests held by pass-through entities.

(25) The U.S. model treaty exempts from source-country taxation gains from the alienation of ships, aircraft, or containers operated in international traffic. The proposed treaty limits the application of this exemption to enterprises that themselves operate ships or aircraft in international traffic, and expands the exemption to cover also movable property (such as containers) pertaining to the operation of the ships or aircraft.

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[6] The exception from the saving clause for this rule was omitted from the proposed treaty as signed (and as submitted to the Senate) (Article 29(3)). By exchange of diplomatic notes on the 19th and 20th of December, 1994, the United States and France added the exception for this rule. As corrected, Article 29(3) of the proposed treaty provides as follows (with the additional clause emphasized):

> 3. The provisions of paragraph 2 shall not affect:
> (a) the benefits conferred under paragraph 2 of Article 9 (Associated Enterprises), *under paragraph 3(a) of Article 13 (Capital Gains)*, under paragraph 1(b) of Article 18 (Pensions), and under Articles 24 (Relief from Double Taxation), 25 (Non-Discrimination), and 26 (Mutual Agreement Procedure); and
> (b) the benefits conferred under Articles 19 (Public Remuneration), 20 (Teachers and Researchers), 21 (Students and Trainees), and 31 (Diplomatic and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, the United States.

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(26) The proposed treaty exempts all other gains from source-country taxation, including gains realized by enterprises that do not themselves operate ships or aircraft on the alienation of containers used in international traffic, except where attributable to a permanent establishment in the source country.

(27) In a manner similar to the U.S. model treaty, Article 14 of the proposed treaty provides that income derived by a resident of one of the treaty countries from the performance of professional or other personal services in an independent capacity generally would not be taxable in the other treaty country unless the person has or had a fixed base in the other country regularly available for the performance of his or her activities; in such a case, the other country would be permitted to tax the income from services performed in that country as are attributable to the fixed base.

(28) Unlike the U.S. model treaty but like the present treaty, Article 14(4) of the proposed treaty provides a special rule for the taxation of services performed through a partnership. Although look-through treatment generally applies, France would not be obligated under the treaty, including under Article 24 (Relief from Double Taxation), to exempt more than half of the earned income of a partnership accruing to a resident of France. To the extent this rule applies, compensating adjustments would be made to the taxation by France of nonresident partners.

(29) The dependent personal services article of the proposed treaty (Article 15) varies slightly from that article of the U.S. model. Under the U.S. model, salaries, wages, and other similar remuneration derived by a resident of one treaty country in respect of employment exercised in the other country is taxable only in the residence country (i.e., is not taxable in the other country) if the recipient is present in the other country for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned and certain other conditions are satisfied. The proposed treaty contains a similar rule, but provides that the measurement period for the 183-day test is not limited to the taxable year; rather, the source country may not tax the income if the individual is not present there for a period or periods exceeding in the aggregate 183 days in a 12-month period.

(30) The proposed treaty allows directors' fees derived by a resident of one treaty country for services performed in the other country in his or her capacity as a member of the board of directors (or another similar organ) of a company which is a resident of the other country to be taxed in that other country (Article 16). The U.S. model treaty, on the other hand, generally treats directors' fees under other applicable articles, such as those on personal service income. Under the U.S. model (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty the country where the company is resident has full taxing jurisdiction over directors' fees and other similar payments the company makes to residents of the other treaty country, regardless of where the services are performed. Thus, the proposed treaty represents a compromise between the U.S. model and the OECD model positions.

(31) Similar to the U.S. model treaty, Article 17 of the proposed treaty allows a source country to tax income derived by artistes and sportsmen from their activities as such, without regard to the existence of a fixed base or other contacts with the source country, if that income exceeds $10,000 in a taxable period. The $10,000 threshold is the same as in the present treaty, but is half of the threshold provided in the U.S. model treaty. U.S. income tax treaties generally follow the U.S. model rule, but often use a lower annual income threshold. Under the OECD model, entertainers and sportsmen may be taxed by the country of source, regardless of the amount of income that they earn from artistic or sporting endeavors.

The proposed treaty includes an exception from source country taxation of artistes and sportsmen resident in the other country if the visit to the source country is principally supported, directly or indirectly, by public funds from the country of residence. Neither the U.S. model nor the OECD model contains such an exception, although it is found in some recent U.S. tax treaties.

(32) The U.S. model treaty provides that pensions (other than those relating to government service) and other similar remuneration derived and beneficially owned by a resident of a treaty country in consideration of past employment are taxable only in the residence country. Article 18 of the proposed treaty similarly applies this rule to private pensions, and provides that the timing and extent of taxation of pension benefits is determined under the laws of the source country. Similar to the U.S. model treaty, the proposed treaty allows taxation of social security benefits and governmental pensions (including U.S. Tier 1 Railroad Retirement benefits) paid to treaty-country residents only by the paying country. Thus, the treaty specifies that only France would be permitted to tax French social security benefits received by a U.S. citizen who is resident in France. The proposed treaty also provides for mutual recognition of tax-favored retirement arrangements, as may be agreed by the competent authorities of the two countries.

(33) Unlike the U.S. model treaty, the proposed treaty makes no special provision for the treatment of alimony or child-support payments. Taking into account the "other income" article, the result in the case of alimony is generally similar to that under the model; the result in the case of child support may not be.

(34) Article 19 of the proposed treaty modifies the U.S. model rule, that compensation paid by a treaty country government to its citizen for services rendered to that government in the discharge of governmental functions may only be taxed by that government's country. The proposed treaty applies its corresponding rule to all compensation paid by a governmental entity for services rendered to that governmental entity, regardless of whether the services are rendered in the discharge of governmental functions, so long as the services are not rendered in connection with a business carried on by the governmental entity. Moreover, unlike the U.S. model treaty, the proposed treaty specifies that compensation by a governmental entity would be taxable only by the other country if the services are rendered in that other country, and the individual is a resident and citizen of that other country and not also a citizen of the paying country. This rule is similar to the corresponding rule

in the OECD model treaty. A similar rule applies to governmental pensions.

(35) Unlike the U.S. and OECD model treaties, but like the present treaty and a number of existing U.S. treaties with other countries, the proposed treaty generally prohibits host country tax on the teaching income of a resident of one country who visits the other (host) country for two years or less to teach at a recognized educational institution (Article 20). Also unlike the models, but like the present and some other existing treaties, this same rule also applies under the proposed treaty to income received as a researcher engaged in research for the public benefit.

(36) The U.S. model, the OECD model, and the proposed treaty (Article 21) all provide a general exemption from host-country taxation of certain payments from abroad received by students and trainees who are or were resident in one country and studying or training in the host country. Whereas the U.S. and OECD models permit this exemption without regard to any income threshold, the proposed treaty, in certain cases, allows it only for certain limited time periods. Unlike the models, the proposed treaty would also exempt anywhere from $5,000 to $8,000 per year (depending on the circumstances) of personal services income of persons who qualify for benefits under this article of the proposed treaty.

(37) The proposed treaty, like the present treaty, contains the standard "other income" article, found in the U.S. and OECD model treaties and more recent U.S. treaties, under which income not dealt with in another treaty article generally may be taxed only by the residence country (Article 22).

(38) Under Article 23 of the proposed treaty, as under the U.S. and OECD model treaties, capital may be taxed by the country in which located if it is real property owned by a resident of either country, or if it is personal property forming part of the business property of a permanent establishment or fixed base maintained by a resident of the other country. The owner's country of residence may also tax that property. The right to tax ships, aircraft, and related movable property (including containers) operated in international traffic belongs solely to the country in which the owner resides. The proposed treaty also allows a country to tax the capital represented by a substantial interest in a company that is a resident of that country. All other capital of a resident of a treaty country is taxable only in the residence country. The proposed treaty provides a special rule under which France may not impose its wealth tax on the foreign property of a U.S. citizen (not also a French citizen) resident in France for the first five years of French residency.

The French wealth tax is the only capital tax imposed under present law by either the United States or France.

(39) The relief from double taxation article of the proposed treaty (Article 24) is substantially the same as the corresponding article of the present treaty. It relieves double taxation by means of a foreign tax credit allowed by the United States, a combination of a credit and an exemption allowed by France, and rules of application generally specifying that the country obligated to offer the credit or exemption is the country other than the one to which the

proposed treaty accords the primary right to tax the applicable category of income.

The article provides special rules for U.S. citizens who reside in France. In this case, the proposed treaty provides that items of income which may be taxed by the United States solely by reason of citizenship (under the saving clause) are to be treated as French source income to the extent necessary to avoid double taxation. In no event, however, would the tax paid to the United States be less than the tax that would be paid if the individual were not a U.S. citizen. This rule is similar to corresponding rules in several recent U.S. treaties.

(40) The proposed treaty contains a nondiscrimination article (Article 25) similar to the nondiscrimination articles contained in the U.S. and OECD model treaties and other recent U.S. treaties. As noted above, however, unlike most other U.S. income tax treaties and the model treaties, the nondiscrimination rules of the proposed treaty do not apply to citizens or nationals of a treaty country who are not residents of that treaty country.

The proposed treaty's nondiscrimination article explicitly permits France to impose its earnings stripping rules, so long as the application of those rules is consistent with the arm's length principles of the associated enterprises article. The Technical Explanation states that the treaty negotiators agreed not to include a similar explicit provision respecting the U.S. earnings-stripping rules, based on the fact that the U.S. earnings-stripping rules were designed to be consistent with such principles.

(41) Under the proposed treaty's mutual agreement procedure rules (Article 26), a case must be presented for consideration to a competent authority within three years from the notification of the action resulting in taxation not in accordance with the provisions of the proposed treaty. The U.S. model does not specify any time limit for presentation of a case to a competent authority, whereas the OECD model provides an identical three-year time limit for this purpose. It is understood that the time limit is included in the interests of good tax administration.

(42) The mutual agreement article of the proposed treaty also specifically permits competent authority agreements that cover future as well as past years. This clarifies that the French government may enter into bilateral advance pricing agreements (APAs).

(43) The proposed treaty, like the U.S. treaties with Germany, Mexico, and the Netherlands, provides for a binding arbitration procedure to be used to settle disagreements between the two countries regarding the interpretation or application of the treaty (Article 26(5)). The arbitration procedure can only be invoked by the agreement of both countries. The effective date of this provision is delayed until the two countries have agreed that it will take effect, to be evidenced by a future exchange of diplomatic notes.

(44) The proposed treaty, in its exchange of information article (Article 27), provides authorization for representatives of one treaty country to enter the other treaty country for the purpose of interviewing taxpayers and examining books and records, but only with the consent of the affected taxpayers and of the competent authority of the second treaty country. The effective date of this provision

is delayed until the two countries have agreed that it will take effect, to be evidenced by a future exchange of diplomatic notes.

(45) The proposed treaty contains a provision requiring each country to undertake to lend administrative assistance to the other in collecting taxes covered by the treaty (Article 28). This provision, carried over with minor modifications from the present treaty, is more detailed than the administrative assistance provision in the U.S. model treaty. Among other things, the proposed treaty provision specifies that one country's application to the other for assistance must include a certification that the taxes at issue have been "finally determined."

(46) As a general rule, the proposed treaty would not restrict the availability of any benefit allowed by any other agreement (present or future) between the United States and France (Article 29(1)).

(47) The proposed treaty provides that its dispute resolution procedures under the mutual agreement article would take precedence over the corresponding provisions of any other agreement between the United States and France in determining whether a law or other rule is within the scope of the proposed treaty (Article 29(8)). Unless the competent authorities agree that the law or other rule is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the most-favored-nation or national-treatment rules of any trade or investment agreement in effect between the United States and France, generally would apply to that law or rule. The only exception to this general rule is that the most-favored-nation and national-treatment rules of the General Agreement on Tariffs and Trade would continue to apply with respect to trade in goods.

(48) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article (Article 30) that retains in some respects the outline of the limitation on benefits provisions contained in recent U.S. treaties and in the branch tax provisions of the Internal Revenue Code and Treasury Regulations. However, the proposed treaty provision is more detailed, and in some respects may be more generous to foreign persons, than recently negotiated provisions in most other treaties. The proposed treaty provision is similar to the limitation on benefits articles contained in the recent U.S. income tax treaty and protocol with the Netherlands.

(49) The proposed treaty would enter into force on the date of the exchange of instruments of ratification. The proposed treaty provisions respecting the rates of taxes collected by withholding generally would apply to amounts paid on or after the first day of the second month following the date on which the treaty enters into force. With respect to taxes other than withholding taxes, the proposed treaty would be effective for taxable periods beginning on or after the first day of January next following the date on which the treaty enters into force. As discussed above, the reduced *avoir fiscal*, would be effective for distributions paid after December 31, 1990 (Article 33).

II. ISSUES

The proposed tax treaty between the United States and France presents the following specific issues.

A. Treaty Shopping

In general

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

The proposed treaty, like a number of U.S. income tax treaties, generally limits the class of treaty country residents eligible for benefits. Benefits are bestowed only upon those treaty country residents with a sufficient additional nexus, beyond simple residence, to the treaty country. In its outlines, the anti-treaty-shopping provision of the proposed treaty is somewhat similar to the anti-treaty-shopping provision in the branch tax provisions of the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties. In its details, on the other hand, the proposed treaty resembles only the 1993 U.S. treaty with the Netherlands, which was in many ways unprecedented. The degree of detail included in this provision and in the Netherlands provision, relative to other treaties, is notable in itself. First, the proliferation of detail may reflect, in part, a diminution in the scope afforded the IRS and the courts in the anti-treaty-shopping provisions of most previous U.S. treaties to resolve interpretive issues adversely to a person attempting to claim the benefits of the treaty; this diminution represents a bilateral commitment, not alterable by developing internal U.S. tax policies, rules, and procedures, unless enacted as legislation that would override the treaty. (To the same extent as is provided under other treaties, the IRS generally is not limited under the proposed treaty in its discretion to *allow* treaty benefits under the anti-treaty shopping rules.) In addition, the detail in the proposed treaty represents added guidance for taxpayers that may be absent under most other treaties, although the negotiators of most other U.S. treaties have chosen to forego such additional guidance in favor of somewhat simpler and more flexible provisions. In general, the provisions of the anti-treaty shopping article of the proposed treaty tend to be at least somewhat more lenient than the comparable rules in the U.S. regulations under the branch tax, and other U.S. treaties, although every existing anti-treaty-shopping standard potentially may be satisfied through the exercise of more or less broad discretion of the Secretary of the Treasury. The proposed treaty is also one of the first to provide mechanical rules under which so-called "derivative benefits" are afforded.[7] Under these rules, a French entity is afforded benefits based in part on its ultimate ownership by a third-country resident who would be entitled to U.S. treaty benefits under an existing treaty between the United States and the third country.

Analysis of provision

Anti-treaty-shopping articles in treaties often have an "ownership/base erosion" test. To qualify for benefits under such a test, an entity must meet two requirements, one concerning the connection of its owners to the treaty countries (the "ownership" requirement), the other concerning the destination of payments that it deducts from its income (the base reduction or "erosion" requirement). The ownership requirement in one anti-treaty-shopping provision proposed at the time the U.S. model treaty was proposed allows benefits to be denied to a company residing in a treaty country unless more than 75 percent of its stock is held by individual residents of the same country. The proposed treaty (like other U.S. treaties and an anti-treaty-shopping branch tax provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include entities and individuals resident in either treaty country (and citizens of the United States). For some purposes, the proposed treaty, unlike most previous treaties, broadens the class of qualifying shareholders to take into account also residents of member countries in the European Union (the "EU") with which the United States and France each has a bilateral income tax treaty. Thus, the ownership requirement under the proposed treaty is somewhat more generous to taxpayers than some predecessor requirements. Counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits. Counting for this purpose residents of EU member countries generally may also limit abuses in light of the treaties between the United States and those countries.

The base erosion requirement in recent treaties allows benefits to be denied if 50 percent or more of the resident's gross income is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to certain classes of persons not entitled to treaty benefits. A similar test applies under the branch tax. The "base reduction" test in the proposed treaty modifies this test in several respects. First, it does not count the use of income to meet liabilities, contracted at arm's length, to obtain tangible property in the ordinary course of business, or services performed in the payer's residence country. In some cases, payments to residents of EU member countries are also afforded favorable treatment. Thus,

[7] The U.S. income tax treaty with the Netherlands also provides for such benefits, as do, in a much more limited way, the U.S. tax treaties with Jamaica and Mexico.

the base-reduction test in the proposed treaty, like the similar test in the U.S.-Netherlands treaty, is different, and may be more favorable to taxpayers, than most of its predecessors.

Another provision of the anti-treaty-shopping article requires a source country to allow benefits with respect to income derived in connection with the active conduct of a trade or business in the residence country that is substantial in relation to the income-producing activity, or derived incidentally to that trade or business. (This active trade or business test generally does not apply with respect to a business of making or managing investments, except for banking or insurance activities conducted by a bank or an insurance company, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) To the extent described above, the proposed treaty's active business test is similar to its predecessors'. In contrast to the practice followed in the drafting of other such treaty tests, however, the way in which the proposed treaty's active business test is to operate is laid out in great detail in the treaty. In some cases, the details mirror provisions in the branch tax regulations, but may be more generous to taxpayers. Like some recent U.S. treaties, the proposed treaty attributes to the treaty resident active trades or businesses conducted by other entities. The attribution rules in the proposed treaty may result in more taxpayers being eligible for treaty benefits, and permit in some cases the treatment of third country business operations as if they were carried on in France. These rules are similar to those in the U.S.-Netherlands treaty.

The proposed treaty is similar to other U.S. treaties and the branch tax rules in affording treaty benefits to certain publicly traded companies. The treaty definition of "publicly traded" is explained in much greater detail in the proposed treaty than in most existing U.S. treaties. Again as in the case of the active business test, in some cases this elaboration mirrors the branch tax regulations, but is less rigorous. Also like the branch tax rules, the proposed treaty allows benefits to be afforded to the wholly-owned subsidiary of a publicly traded company. Unlike most predecessors, the proposed treaty provides that benefits must be afforded to certain joint ventures of publicly traded companies, including in some cases joint ventures involving publicly traded companies resident in EU member countries other than France. Moreover, unlike the corresponding provision of the U.S.-Netherlands tax treaty, upon which this joint-venture provision is modeled, the proposed treaty does *not* require that if benefits are to be afforded a company resident in a treaty country on the basis of public trading in the stock of the company's shareholder or shareholders, the company seeking treaty benefits also meet an anti-conduit test that measures base erosion.[8] Thus, under the proposed treaty, a joint venture of two

[8] Under the U.S.-Netherlands treaty, the company either must not be a "conduit company" or, if it *is* a conduit company, the company must meet a "conduit company base reduction test." A conduit company is one that pays out currently at least 90 percent of its aggregate receipts in deductible payments (including royalties and interest, but excluding those at arm's length for tangible property in the ordinary course of business or services performed in the payer's residence country). A conduit company meets the conduit base reduction test if less than a threshold fraction (generally 50 percent) of its gross income is paid to associated enterprises subject to a particularly low tax rate (relative to the tax rate normally applicable in the payer's residence country).

publicly traded companies could qualify for treaty benefits even if most of its gross income avoids taxation in France through base erosion. However, there may be significantly less potential for tax avoidance through base erosion under the tax laws of France than in the Netherlands.

The proposed treaty also guarantees benefits to a resident that is a "headquarter company" of a multinational corporate group. A headquarter company is one that provides a group which is sufficiently geographically dispersed with substantial supervision and administration (including group financing if that is not its primary function). One requirement to qualify as a headquarter company in the proposed treaty is that the headquarter company must be subject to tax in its residence country on the same basis as a company conducting an active trade or business there. The Technical Explanation states that headquarter companies in France are not so taxed. Therefore, under present law, no French company is able to qualify as a headquarter company under the proposed treaty.

The proposed treaty includes a special rule designed to prevent the proposed treaty from reducing or eliminating U.S. tax on income of a French resident in a case where no other substantial tax is imposed on that income. This is necessary because a French resident may in some cases be wholly or partially exempt from French tax on foreign (i.e., non-French) income. The special rule applies generally if the combined French and third-country taxation of third-country income earned by a French enterprise with a permanent establishment in the third country is less than 60 percent of the tax that would be imposed if the French enterprise earned the income in France.

In such a case, under the special rule, the United States is permitted to tax dividends, interest, and royalties paid to the third-country permanent establishment at the rate of 15 percent. In addition, under the special rule, the United States is permitted to tax other types of income without regard to the treaty. The special rule generally does not apply if the U.S. income is in connection with or incidental to an active trade or business in the third country, or if the third-country income is subject to taxation by either the United States or France under the controlled foreign corporation rules of either country.[9] The special rule is similar to a provision of the 1993 protocol to the U.S.-Netherlands tax treaty.

Like other treaties and the branch tax rules, the proposed treaty gives the competent authority of the source country the power to allow benefits where the anti-treaty-shopping tests are not met. The proposed treaty states that benefits are to be allowed in a case where the competent authority of the country allowing the benefits determines that obtaining treaty benefits was not one of the principal purposes in establishing, acquiring, or maintaining the treaty-country person, or in conducting its operations. The proposed treaty also states that benefits are to be allowed in a case where the competent authority of the country allowing the benefits determines that it would not be appropriate, considering the purposes of the

[9] Article 30(5)(b) of the proposed treaty erroneously refers to subpart F of part II of subchapter N of chapter 1 of subtitle A of the Internal Revenue Code. The Technical Explanation confirms that the negotiators of the proposed treaty intended this reference to refer to subpart F of part III of subchapter N of chapter 1 of subtitle A of the Internal Revenue Code.

anti-treaty-shopping provision, to deny treaty benefits. The Technical Explanation anticipates that the competent authorities will take into account the principles and examples set forth in the Understanding accompanying the limitation-on-benefits provision of the U.S.-Netherlands tax treaty. The proposed treaty requires each competent authority to consult the other before issuing an adverse ruling.

Issue

The practical difference between the proposed treaty tests (and the similar tests in the U.S.-Netherlands treaty) and the corresponding tests in most predecessor treaties will depend upon how they are interpreted and applied. For example, the active business tests in other treaties theoretically might be applied leniently (so that any colorable business activity suffices to preserve treaty benefits), or they may be applied strictly (so that the absence of a relatively high level of activity suffices to deny them). Given the bright line rules provided in the proposed treaty, the range of interpretation under it may be narrower. It may be possible that a relatively narrow reading of the active business test in other treaties and the branch tax regulations could theoretically be stricter than the proposed treaty tests, and could operate to deny benefits in potentially abusive situations more often.

The Committee continues to believe that the United States should maintain its policy of limiting treaty-shopping opportunities whenever possible. The Committee continues to believe further that, in exercising any latitude Treasury has to adjust the operation of a treaty, the treaty rules as applied should adequately deter treaty-shopping abuses. On the other hand, implementation of the tests for treaty shopping set forth in the treaty raise factual, administrative, and other issues. For example, as discussed above, the proposed treaty broadly allows treaty benefits to joint ventures of public companies. As another example, the proposed treaty allows the United States to impose higher levels of source tax in certain cases resulting in low overall tax; this is a stronger anti-abuse rule than is found in most recent U.S. treaties. By contrast, one limitation on benefits provision proposed at the time that the U.S. model treaty was proposed provides that any relief from tax provided by the United States to a resident of the other country under the treaty shall be inapplicable to the extent that, under the law in force in that other country, the income to which the relief relates bears significantly lower tax than similar income arising within that other country derived by residents of that other country. The primary issue is whether the anti-treaty-shopping rules in the proposed treaty are adequate under the circumstances.

B. Transfer Pricing

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to reallocate profits among related enterprises residing in each country, if a reallocation is necessary to reflect the conditions which would have been made between independent enterprises. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty.[10] A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise. The arm's-length standard has been adopted uniformly by the leading industrialized countries of the world, in order to secure the appropriate tax base in each country and avoid double taxation, "thereby minimizing conflict between tax administrations and promoting international trade and investment."[11]

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[12] Some prefer a so-called "formulary apportionment" approach, which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach that is based on the expectation that an investor generally will insist on a minimum return on investment or sales.[13]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimination rules embodied in Article 25.[14] Some, who advocate a change

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[10] The OECD draft report on transfer pricing generally approves the methods that are incorporated in the current Treasury regulations under section 482 as consistent with the arm's-length principles upon which Article 9 of the proposed treaty is based. See OECD Committee on Fiscal Affairs, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, Discussion Draft of Part I: Principles and Methods," 1994.

[11] *Id.* (preface).

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

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

[14] Compare *Tax Conventions with: The Russian Federation, Treaty Doc. 102-39; United Mexican States, Treaty Doc. 103-7; The Czech Republic, Treaty Doc. 103-17; The Slovak Republic, Treaty Doc. 103-18; and The Netherlands, Treaty Doc. 103-6. Protocols Amending Tax Conventions with: Israel, Treaty Doc. 103-16; The Netherlands, Treaty Doc. 103-19; and Barbados, Treaty Doc. 102-41. Hearing Before the Committee on Foreign Relations, United States Senate*, 103d Cong., 1st Sess. 38 (1993) ("A proposal to use a formulary method would be inconsistent with our existing treaties and our new treaties.") (oral testimony of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Treasury Department); a statement conveyed by foreign governments to the U.S. State Department that "[w]orldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State); and *American Law Institute Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties* (1992), at 204 (n. 545) ("Use of a world-wide combination unitary apportionment method to determine the income of a corporation is inconsistent with the 'Associated En-

in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

C. Relationship to Other Treaties and Agreements

Uruguay Round trade agreements

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

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

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

terprises' article of U.S. tax treaties and the OECD model treaty") with *Hearing Before the Senate Committee on Governmental Affairs* at 26, 28 ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder). See also *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means,* 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

be brought before the Council for Trade in Services only with the consent of both parties to the tax agreement.

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

The proposed treaty provides, in Article 29(8), that notwithstanding any other agreement to which the United States and France are parties, a dispute concerning whether a measure is within the scope of the proposed treaty is to be considered only by the competent authorities under the dispute settlement procedures of the proposed treaty. Moreover, the proposed treaty provides that the nondiscrimination provisions of the proposed treaty are the only nondiscrimination provisions that may be applied to a taxation measure unless the competent authorities determine that the taxation measure is not within the scope of the proposed treaty (with the exception of nondiscrimination obligations under the General Agreement on Tariffs and Trade (GATT) with respect to trade in goods).

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

Other treaties and agreements

The proposed treaty provides that, except as discussed above, it would not restrict any treaty benefits accorded by any other agreement between the United States and France. One existing treaty in force between the United States and France that includes tax-related provisions is the 1959 Convention of Establishment between the United States and France (hereinafter "1959 Convention").

Some have argued that one portion of the nondiscrimination provisions of the 1959 Convention (Article IX, Paragraph 4) may preclude application of a formulary method of taxation on a worldwide unitary basis either by the United States or by any State. That paragraph protects enterprises of one treaty country from taxation within the territories of the other treaty country "upon capital, income, profits or any other basis, except by reason of the property which they possess within those territories, the income and profits derived from sources therein, the business in which they are there engaged, the transactions which they accomplish there, or any other bases of taxation directly related to their activities within those territories." On this basis, some have argued that the paragraph requires that taxation be imposed on a "water's edge" basis.

Even if, as some have argued, the nondiscrimination provisions of the 1959 Convention may limit the scope or structure of U.S. taxation of French enterprises under present law, Article 29(8) of the proposed treaty may preclude any such limitation as discussed above.[15] The Committee may wish to evaluate the effect, if any, of the 1959 Convention on the tax jurisdiction of the United States and France.

D. Insurance Excise Tax

The proposed treaty, like the present treaty, covers the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a French insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the French insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Although waiver of the excise tax appears in the 1981 U.S. model treaty, waivers of the excise tax have raised serious congressional concerns. For example, concern has been expressed over the possibility that they may place U.S. insurers at a competitive disadvantage to foreign competitors in U.S. markets, if a substantial tax is not otherwise imposed (e.g., by the treaty partner country) on the insurance income of the foreign insurer (or, if the risk is reinsured, the reinsurer). Moreover, in such a case waiver of the tax does not serve the purpose of treaties to avoid double taxation, but instead has the undesirable effect of eliminating all taxation.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress.[16] Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The waiver of the tax in the treaty with the United Kingdom (where the tax was waived without the so-called "anti-conduit rule") has been followed by a number of legislative efforts to redress perceived competitive imbalance created by the waiver.

The issue is whether the waiver of the insurance excise tax in the proposed treaty is consistent with the Committee's view of good tax treaty policy. The Technical Explanation states that the Treasury Department's review of French law indicated that the income tax imposed by France on French resident insurance companies results in a burden that is substantial in relation to the U.S. tax on U.S. resident insurance companies. Unlike the U.K. waiver, moreover, the French treaty waiver contains the standard anti-conduit language. Although it may be difficult to generalize about the precise tax burdens French insurers bear relative to U.S. insurers, or the precise effects of imposing or waiving the excise tax on French insurers' rates of economic return, there is reason to believe that

[15] Although some may argue that Article IX(4) of the 1959 Convention is not a nondiscrimination provision because it addresses neither national treatment nor most-favored-nation treatment, and thus would be unaffected by the proposed treaty, a leading commentator on nondiscrimination provisions in tax treaties considers that provision to be a nondiscrimination provision. C. Van Raad, *Nondiscrimination in International Tax Law* (1986) at 240-241.

[16] Such consultations took place in connection with the proposed treaty.

failure to impose the tax on French insurers is consistent with the criteria the Committee has previously laid down for waiver of the tax.

E. Exchange of Information

In most respects, the present treaty is similar to the U.S. model treaty and other U.S. treaties in its provisions on the exchange of information. The exchange of information provision serves the function of preventing fiscal evasion, one of the two principal reasons for which the United States enters into tax treaties. In one significant respect, however, the information-exchange provision of the proposed treaty provides narrower opportunities for obtaining tax information from the treaty partner than does the usual tax treaty relationship.

The proposed treaty provides for representatives of one country to enter the other country to interview taxpayers and to examine and copy books and records, but only with the consent of the taxpayer and of the other competent authority. Moreover, this provision will not be effective until the United States and France agree to allow such interviews and examinations on a reciprocal basis, and signify that agreement in an exchange of diplomatic notes. That is, unless and until a subsequent agreement is reached, the United States has no authority under the treaty to enter France for audit purposes. Even after such agreement is reached, the authority to conduct such audits in France would be severely limited, and (as under some other U.S. treaties) would be available at all only with the consent of the taxpayer.

However, the opportunities for obtaining tax information from the France would be significantly greater under the proposed treaty than under present law and practice. Staff understand that French law precludes foreign government authorities, including agents of the United States and other treaty partners, from conducting on-site tax examinations in France even with consent of the taxpayer. There is no current limitation applicable to examinations by French authorities in the United States. The proposed treaty would restore reciprocity to this relationship, and may serve to encourage France to modify its internal laws so that both countries could more effectively enforce their tax laws..

The Committee may wish to consider the extent to which the limited examination opportunities under the proposed treaty would be adequate to allow the United States to properly determine the tax obligations of French persons, and to confine the benefits of the French treaty to those taxpayers entitled to receive them.

F. Arbitration of Competent Authority Issues

In a step that has been taken only recently in U.S. income tax treaties (i.e., beginning with the 1989 income tax treaty between the United States and Germany), the proposed treaty would make provision for a binding arbitration procedure, if both competent authorities and the taxpayers involved agree, for the resolution of those disputes in the interpretation or application of the treaty that it is within the jurisdiction of the competent authorities to resolve. This provision would have effect only after diplomatic notes are exchanged between France and the United States. Consultation between the two countries regarding whether such an exchange of notes should occur would take place after a period of three years after the proposed treaty has entered into force.

Generally, the jurisdiction of the competent authorities under the proposed treaty would be as broad as it is under any U.S. income tax treaties. Specifically, the competent authorities would be required to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They could also consult together regarding cases not provided for in the treaty.

As an initial matter, it is necessary to recognize that there are appropriate limits to the competent authorities' own scope of review.[17] The competent authorities would not properly agree to be bound by an arbitration decision that purported to decide issues that the competent authorities would not agree to decide themselves. Even within the bounds of the competent authorities' decision-making power, there likely would be issues that one or the other competent authority would not agree to put in the hands of arbitrators. Consistent with these principles, the Technical Explanation expects that the arbitration procedures will ensure that the competent authorities would not accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country.

In approving ratification of the U.S.-Germany treaty, the Committee indicated a belief that the tax system potentially may have as much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes which otherwise may impede efficient administration of the tax laws. However, the Committee also believed that the appropriateness of such a clause in a future treaty depended strongly on the other party to the treaty, and the experience that the competent authorities would have under the provision in the German treaty. To date there have been no arbitrations of competent authority cases under the German treaty, and few tax arbitrations outside the context of that treaty.

G. Technical Clarifications

Stock exchange excise tax

Under the present treaty, the French tax on stock exchange transactions is a covered tax. That is, the tax could not be imposed on a resident of the United States. In the proposed treaty, however, the French tax on stock exchange transactions is not a covered tax, but Article 29(4) provides that any transaction in which an order for the purchase, sale, or exchange of stocks or securities originates in one treaty country and is executed through a stock exchange in

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[17] In discussing a clause permitting the competent authorities to eliminate double taxation in cases not provided for in the treaty, Representative Dan Rostenkowski, then Chairman of the House Committee on Ways and Means, submitted the following testimony in 1981 hearings before the Senate Committee on Foreign Relations:

> Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope of this delegation of authority must be clarified and limited to include only noncontroversial technical matters, not items of substance.

Tax Treaties: Hearings on Various Tax Treaties Before the Senate Committee on Foreign Relations, 97th Cong., 1st Sess. 58 (1981).

the other treaty country is exempt in the first country from stamp or like tax otherwise arising with respect to such transaction. The apparent difference between these provisions is that the French tax on stock exchange transactions could be imposed, under the proposed treaty, on a U.S. resident who engages in a stock exchange transaction while in France on a temporary basis. However, staff understand that French law now exempts nonresident individuals and foreign legal persons from the tax on stock exchange transactions.

Treatment of partnerships

As noted above, the proposed treaty provides that a partnership or other entity that is subject to tax by a treaty country at the entity level would be treated as a resident of that country under the treaty. Article 4(2)(b)(iv) specifies that a *société de personnes*, a *groupement d'intérêt économique* (economic interest group), or a *groupement européen d'intérêt économique* (European economic interest group) that is constituted in France and has its place of effective management in France and that is not subject to French company tax would be treated as a partnership for purposes of U.S. tax benefits under the proposed treaty. Moreover, diplomatic notes exchanged between the United States and France on the date that the proposed treaty was signed specify also that such an entity, if so constituted, effectively managed, and not subject to tax, also would be treated as a partnership for purposes of U.S. tax benefits under any U.S. tax treaty with any third country. Although the effect of these diplomatic notes appears to pose a potential conflict with other tax treaties to which France is not a party, staff is assured by the Treasury Department that the treatment specified in the diplomatic notes is fully consistent with every other U.S. tax treaty.

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

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

A. United States Tax Rules

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

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

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

Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions from withholding taxes are provided. For example, interest on deposits with banks or savings institutions is exempt from tax unless the interest is effectively connected with the conduct of a U.S. trade or business carried on by the recipient. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio debt obligations is exempt from the 30-percent tax. Certain U.S. income tax treaties also provide for exemption from tax in certain cases.[18]

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

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

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

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

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

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

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

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

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

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives; the treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty country. Given the diversity of tax systems, it would be very difficult to develop in the Code rules that unilaterally would achieve these objectives for all countries.

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

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

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

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

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

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

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

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

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

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

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

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

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