[JOINT COMMITTEE PRINT]

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

PREPARED FOR THE USE OF THE

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INTRODUCTION

The proposed protocol to the income tax treaty between the United States and France was signed on November 24, 1978. A clarifying Exchange of Notes was signed on the same day. The protocol would amend the current U.S.–France income tax treaty, which entered into force on July 11, 1968. (The treaty was previously amended by another protocol which entered into force on January 21, 1972.) A public hearing on the proposed protocol is scheduled on June 6, 1979, by the Senate Committee on Foreign Relations.

The primary reason for negotiation of the protocol was a change in French domestic law which, effective January 1, 1979, for the first time subjected U.S. citizens resident in France to French tax on their worldwide income, including income from the United States. Prior to that time, these individuals were taxed by France on only their French-source income. This change could have resulted in significant double taxation of these individuals by France and the United States. The proposed protocol alleviates the impact of the new French law, essentially by dividing the tax revenue from U.S.-source income of these individuals between the U.S. and French Treasuries.

In the course of their negotiations concerning the double taxation issue, the U.S. and French representatives also agreed on a number of other changes to the existing treaty. Some of these changes deal with specific problems which have arisen in the administration of the treaty, while others generally modernize the treaty, bringing it into closer conformity with the current U.S. model income tax treaty.

The first part of the pamphlet is a summary of the principal provisions of the proposed protocol. This is followed by a detailed, article-by-article explanation of the protocol.

I. SUMMARY

The proposed protocol to the income tax treaty between the United States and France contains the following provisions:

(1) Double taxation by the United States and France of U.S. citizens who are French residents is avoided by division of the tax liability of these individuals between the United States and France. In general, France agrees not to tax these individuals on some of their U.S.-source business income, and to give a credit for some of the U.S. tax on their U.S.-source investment income. The United States in turn agrees to treat some of this income as from French sources, which would make French taxes on the income eligible for the U.S. foreign tax credit against their U.S. tax liability. Special rules are prescribed for taxing the income of partners of partnerships with income from U.S. sources and retirees whose pensions are attributable to U.S. sources.

(2) The United States generally agrees to exempt French insurers from the U.S. excise tax on foreign insurance of U.S. risks.

(3) The geographical scope of the treaty is revised so that the treaty expressly covers income from natural resources on each country's continental shelf.

(4) The provisions governing shipping and air transport are revised to bring them into closer conformity with the U.S. model income tax treaty. Changes are also made to the rules for taxing employees of shipping companies.

(5) Interest paid to banks is exempted from the 10-percent withholding tax allowed under the existing treaty.

(6) Social security payments made by either country to a U.S. citizen are exempted from tax by the other country.

(7) The "saving clause" of the treaty, which generally allows the United States to tax its own citizens and residents without regard to the treaty, is clarified so that it expressly applies to certain former U.S. citizens who expatriated to avoid U.S. tax.

A detailed, article-by-article explanation of the proposed protocol to the income tax treaty between the United States and France is presented below.

II. EXPLANATION OF PROPOSED PROTOCOL

Article 1. Substantive provisions

Article 1 of the protocol contains in ten paragraphs the substantive provisions of the agreement.

Paragraph 1.—Taxes covered (including U.S. insurance excise tax)

Paragraph 1 amends the existing treaty to provide that the U.S. excise tax on insurance premiums paid to a foreign insurer is a tax covered by the treaty. Under the Internal Revenue Code, premiums from insuring U.S. risks which are received by a foreign insurer having no U.S. trade or business are not subject to U.S. income tax but are subject to the U.S. insurance excise tax (Code secs. 4371–4373). However, the proposed protocol includes the insurance excise tax among the U.S. taxes covered by the French treaty, and thus, under the business profits Article of the treaty and Article 22 (*General rules of taxation*), income of a French insurer from the insurance of U.S. risks will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exemption) if that insurance income is not attributable to a U.S. permanent establishment maintained by the French insurer. This treatment is a departure from the existing tax treaty with France and other U.S. tax treaties, except for the proposed tax treaties with the United Kingdom and Hungary. However, the excise tax on premiums paid to foreign insurers is a covered tax under the U.S. model income tax treaty.

Under the Internal Revenue Code (in the absence of a contrary treaty provision), a foreign insurer is subject to U.S. income tax on income derived from the insurance of risks situated in the United States in situations where that insurance income is effectively connected with a U.S. trade or business. A foreign insurer insuring U.S. risks ordinarily will not be viewed as conducting a U.S. trade or business and thus will not be subject to U.S. income tax if it has no U.S. office or agent and operates in the United States solely through independent brokers.

In these situations, a foreign insurer is not subject to U.S. income tax, but the insurance excise tax is imposed (except as otherwise provided in a treaty) on the premiums paid for that insurance.[1] The excise tax may be viewed as serving the same function as the withholding tax imposed on dividends, interest, and other types of passive income paid to foreign investors. In general, the excise tax applies to insurance covering risks wholly or partly within the United States where

[1] The excise tax is imposed at a rate of 4 percent of the premiums paid on casualty insurance and indemnity bonds, and one percent of the premiums paid on life, sickness, and accident insurance, annuity contracts, and reinsurance.

the insured is (i) a U.S. person or (ii) a foreign person engaged in a trade or business in the United States. Under the Code, the excise tax generally applies to any such life, sickness, or accident insurance, or annuity contract unless the foreign insurer is subject to U.S. income tax. It generally applies to any such casualty policy written by an insurer company unless the policy is placed through an officer or agent of the foreign insurer within a state in which the insurer is authorized to do business.

The treatment of insurance income of foreign insurers is complicated somewhat in situations where, as is usually the case, some portion of the risk is reinsured with other insurers in order to spread the risk. In situations where the foreign insurer is engaged in a U.S. trade or business and thus subject to the U.S. income tax, reinsurance premiums, whether paid to a U.S. or a foreign reinsurer, are allowed as deductions. Accordingly, the foreign insurer is taxable only on the income attributable to the portion of the risk it retains. However, while no excise tax is imposed on the insurance policy issued by the foreign insurer doing business in the United States (and, in the case of casualty insurance, the policy is written by an officer or agent of the insurer within a State in which it is authorized to do business), the one-percent excise tax on reinsurance is imposed if and when that insurer reinsures that U.S. risks with a foreign insurer not doing business in the United States (and not subject to U.S. income tax).

The statutory rules governing the taxation of foreign insurers insuring U.S. casualty risks have been modified through interpretations of treaties contained in certain closing agreements which have been entered into between the IRS and a number of foreign insurers.[2] The closing agreements are intended to provide relief in those situations where there is the potential for both income tax and excise tax liability because the foreign insurer is subject to the income tax (because it is engaged in a U.S. trade or business) and the excise tax (because it is not licensed by a state to write insurance). It is understood that, if there is a tax treaty between the United States and the country of which the foreign insurer is a resident and the treaty includes an appropriate nondiscrimination clause, the foreign insurer agrees in the closing agreement to subject itself to the U.S. income tax by treating its U.S. operations (frequently an unrelated agent) as a permanent establishment, and the IRS agrees to waive the excise tax on premiums effectively connected with that U.S. trade or business under the nondiscrimination clause of the treaty.

In exempting from the U.S. income tax and the insurance excise tax all insurance income which is not attributable to a permanent establishment in the United States, the proposed protocol makes two changes in the statutory rules governing the taxation of insurance income of French insurers. First, any insurance income which is effectively connected with a U.S. trade or business but is not attributable to a U.S. permanent establishment will not be subject to U.S. income tax. This exemption is contained in the existing treaty. Second, French insurers not engaged in a U.S. trade or business will

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[2] One such agreement with a German insurer is described in Letter Ruling 7846060 (Aug. 18, 1978).

no longer be subject to the insurance excise tax. This exemption is not contained in the existing treaty. However, those French insurers which continue to maintain a U.S. permanent establishment after the proposed protocol enters into force will remain subject to the U.S. income tax on their net U.S. insurance income attributable to the permanent establishment.

In addition, the insurance excise tax will continue to apply in situations where a French insurer with a U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign reinsurer other than a resident of France or another insurer entitled to exemption under a different tax treaty (such as the proposed U.S.-U.K. treaty). The tax is imposed on the French insurer which in this situation is viewed as the U.S. resident person transferring the premium to the foreign reinsurer. The excise tax will apply to such reinsurance even where the French insurance company has a U.S. trade or business but no U.S. permanent establishment and thus will not be subject to U.S. income tax on the net income it derives on the portion of the risk it retains.

If the excise tax would apply to premiums paid to the French insurer in the absence of the treaty exemption, the tax will continue to apply to that insurer to the extent of reinsurance with a nonexempt person. For example, a French company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a German insurance company (not currently entitled to exemption from the excise tax) and pays that Germany company a premium of $100. The 4-percent excise tax on casualty insurance applies to the premium paid to the French insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is 4 percent of the portion of its premium to the French insurer which was used by the French insurer to reinsure the risk. It is the responsibility of the U.S. insured to determine to what, if any, extent the risk is to be reinsured with a nonexempt person.

Paragraph 1 of the protocol also deletes from the list of taxes covered by the treaty certain taxes which are no longer in force.

Paragraph 2.—Definitions

The protocol modifies the treaty definitions of "France" and "United States" to include their respective continental shelf areas. The definition of the United States continental shelf is in general accord with the principles of U.S. domestic law (Code sec. 638). Inclusion of these areas within the geographical scope of the treaties permits, for example, the United States to tax the business profits of a French company extracting oil outside U.S. territorial waters but on the U.S. continental shelf. The Treasury Department takes the position that this is a clarification of the provisions of the existing treaty.

The protocol also adds a definition of "international traffic" by ships or aircraft. This is discussed in connection with Paragraph 4 (*Shipping and air transport*).

Paragraph 3.—Partnership income

Paragraph 3 of the proposed protocol adds a new rule to the treaty for taxation of partnership income. In general, a partner's distributive share of partnership income, loss, and other items is to have the same character and source in his hands as those items had in the hands of the partnership. The intent of this provision is to reduce double taxation of partnership income. It is discussed in greater detail in connection with Paragraph 10 of the proposed protocol (*Relief from double taxation*).

Paragraph 4.—Shipping and air transport

The proposed protocol comprehensively revises the rules in the existing treaty which govern taxation of income from shipping and air transport. In general, the changes bring the treaty into closer conformity with the U.S. model income tax treaty. In addition, the proposed protocol would prevent "treaty shopping" by third-country nationals acting through French or U.S. corporations in order to get the benefits intended to be provided to U.S. and French residents.

Under the current treaty, income which a resident of one country derives from the operation in international traffic of ships or aircraft registered in that country is not subject to tax by the other country.

The proposed protocol removes the domestic registration, or "flag," requirement. Thus, income of a U.S. resident from a ship flying the Liberian flag would generally not be subject to French tax. One effect of removal of the "flag" requirement is that French shipping companies and airlines will be able to lease equipment from U.S. owners who obtained the benefits of the investment tax credit. These benefits may be passed on by the U.S. owners to the French shipping companies and airlines in the form of lower rentals. The credit is available for ships and aircraft which are used predominantly outside the United States only if they are registered or documented under U.S. law. (Code sec. 48(a)(2)). Because a French shipping company or airline could benefit from the treaty shipping article only if its equipment flew the French flag, it was not possible under the existing treaty to combine the treaty benefits with those of the investment tax credit. It was made clear by the United States representatives in negotiating this provision that this modification would in no way restrict the right of the United States to amend its statutory investment credit rules so that the credit would not be available to ships or aircraft used predominantly outside the United States by persons exempt from U.S. tax under the treaty.

The protocol amends the shipping article to make it clear that all gains from the sale, exchange or other disposition of ships and aircraft operated in international traffic are also to be covered under the shipping article of the treaty. Thus, these gains generally are taxable only in the country of residence.

The protocol makes the shipping exemption expressly applicable to profits derived from the rental on a full or bareboat basis of ships and aircraft if either the lessee operates them in international traffic or the profits are incidental to the lessor's operation of the ships or aircraft in international traffic. The protocol would also expressly cover profits from the use or maintenance of containers used for the transportation of goods in international traffic if the income is incidental to other income from the operation of ships or aircraft in international traffic. The protocol also makes it clear that the proportionate share of income derived from participation in a pool, joint business or international operating agency is covered by the shipping article to the extent that the pool, joint business, or operating agency derives income from operation in international traffic of ships or aircraft.

The meaning of the term "international traffic" is clarified by Paragraph 2 of the proposed protocol (*Definitions*). The definition is the same as that in the U.S. model income tax treaty. The term "international traffic" means any transport by a ship or aircraft, except where such transport is solely between places in the other country. Thus, coastal shipping along the Atlantic coast of the United States is not international traffic. Nor is transport solely between Metropolitan France and the French Overseas Departments (Guadaloupe, Guiana, Martinique, and Reunion) international traffic. However, transport between France and its overseas territories, such as San Pierre and Miquelon, or between the United States and American Samoa, for example, is international traffic. If a resident of France transports goods by ship from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the transport between New York and Norfolk is international traffic; if it also loads other merchandise in New York which it takes to Norfolk, the income from the transport of the goods loaded in New York is not from international traffic.

The proposed protocol also provides a new rule intended to prevent abuse of the treaty by persons having no substantial economic connection with either treaty partner. Under the provision, a corporation "resident" in the U.S. or France may claim the benefits of the shipping exemption only if more than 50 percent of its capital is owned by the government of that country or residents of that country (or residents of a country with which the other country has a treaty with a similar exemption). The ownership requirement is reduced to 20 percent if more than 50 percent in value of the shares of the corporation or its parent are listed on a recognized exchange and there is substantial trading activity in those shares. Thus, for example, a resident of a country with which the United States has no tax treaty could not establish a wholly-owned French corporation to take advantage of the shipping article and exempt its shipping income from U.S. tax.

For purposes of determining ownership, "capital" includes long-term debt as well as equity. If the French corporation is owned by individual residents of a country with which the United States has a treaty exempting income from ships flying the flag of that country, then the exemption in the United States-France treaty will be available only with respect to ships of French flag or the flag of that country.

Paragraph 5.—Bank interest

The proposed protocol would exempt loan interest from sources in one country from tax by that country if the interest is paid to a bank which is a resident of the other country.

Under the treaty, interest from sources in one country paid to a resident of the other generally is subject to tax by the source country at the rate of 10 percent of the gross amount. However, interest from sources in one country paid to the government of the other country or an instrumentality of that country may not be taxed by the source country.

Under these provisions, there was some question as to whether the Banque Francaise du Commerce Exterieur would qualify as an instrumentality of France, and therefore be eligible for exemption from U.S. tax. The Banque is established by the French government and performs functions similar to those of the U.S. Export-Import Bank. The proposed protocol provides an exemption for interest from sources in one country on loans granted by any bank which is a resident of the other country. This amendment is consistent with the U.S. model income tax treaty which provides for exemption from tax at source by one country for all interest paid to residents of the other country.

The exemption provided by the protocol is subject to the treaty provision that if the recipient of the interest has in the source country a "permanent establishment" (e.g., a branch or office) the interest is taxable under Article 6 (*Business profits*) of the treaty. Also, the exemption would not apply in a case in which a loan by a bank which is a resident of one country to a resident of the other country is followed (or preceded) by a deposit in the bank of a similar amount by a party related to the borrower. For purposes of the exemption, such a transaction would be treated by a loan from the related party, rather than the bank.

Paragraph 6.—Independent personal services

The proposed protocol adds to the treaty a new rule for determining the tax on partners. This provision is part of the protocol's provisions to avoid double taxation of French resident partners of partnerships with U.S.-source income and is described in detail in connection with paragraph 10 of the proposed protocol (*Relief from double taxation*).

Paragraph 7.—Dependent personal services

The proposed protocol prescribes a new rule for the taxation of crew members of ships and aircraft to take into account the protocol's changed rules (paragraph 4 of the proposed protocol) for taxation of income from the operation of the ships and aircraft. Under the new provision, if an individual is a regular crew member of a ship or aircraft and income from the operation of the ship or aircraft is exempt from tax by a treaty partner under the protocol, the crew member's income for services performed on the ship or aircraft is also exempt from tax by that country. The individual need not be a resident of the other treaty country to qualify for this exemption.

If not all of the ship's or aircraft's operations are in international traffic, the crew member's income will still be exempt if his service is in international traffic. For example, if an airline pilot flies from Paris to New York and then continues to Miami, his income from both portions of the journey will be exempt even if all the income of the airline on the New York-to-Miami portion is not exempt.

Paragraph 8.—Social security payments

The existing treaty provides that social security payments made by one country to a resident of the other country may only be taxed by the country making the payment. (The United States under its domestic rules exempts U.S., but not foreign, social security payments from tax.) However, the existing treaty exemption does not cover the case of a U.S. citizen who receives French social security payments and resides outside the United States. The Internal Revenue Service has held that these individuals are subject to U.S. tax on their French social security benefits. (Rev. Rul. 75–489, 1975–2 C.B. 511.) The proposed protocol expands this existing treaty rule, so that social security payments by either country to a U.S. citizen may not be taxed by the other country, regardless of where the U.S. citizen is resident.

The United States allows, within limits, a credit against its tax for income taxes paid to foreign countries. If French social security taxes imposed on employees qualify as creditable income taxes, and if these employees received social security payments from France, these individuals in effect could obtain a double benefit. They could reduce their U.S. tax liability dollar-for-dollar by social security taxes paid to the French government, but if they received social security payments from France, the payments would be exempt from U.S. tax.

Paragraph 9.—U.S. expatriates

Under the Internal Revenue Code, if a U.S. citizen becomes a nonresident alien and one of his principal purposes for giving up his U.S. citizenship is the avoidance of U.S. income, estate or gift taxes, he can be taxed on his U.S. income as though he were a citizen for 10 years after the loss of citizenship (Code sec. 877). If such an individual became a resident of France, he might argue that the existing French treaty prevents this result. The treaty currently contains a "saving clause" under which, with certain specified exceptions, the United States may continue to tax its citizens and residents as if the treaty had not come into effect. The proposed protocol provides that for this purpose the term "citizen" includes a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax. Treatment as a U.S. citizen will continue for a period of 10 years following the loss (the same period contained in the Code). This will generally allow the United States, without regard to the treaty, to impose its tax under Code section 877 on individuals who expatriate to avoid tax. The Treasury Department takes the position that this is a clarifying change and that the treaty benefits would not apply to Americans who expatriate to avoid tax even in the absence of such a provision. Rev. Rul. 79–152, 1979–20, Int. Rev. Bull. 14. The protocol provision is in conformity with the principles of the U.S. model income tax treaty.

Paragraph 10.—Relief from double taxation

Introduction

The proposed protocol thoroughly revises the provisions of the treaty (*Article 23*) which deal with the avoidance of double taxation. The revision became necessary because France amended its laws to tax U.S. citizens resident in France on their worldwide income, including income from U.S. sources. The United States also taxes its citizens, wherever they may be resident, on their worldwide income. The United States generally allows its citizens a credit against their U.S. income tax liability for foreign income taxes paid, but the credit does not apply to foreign taxes on U.S.-source income. Thus, in the absence of treaty provisions, there would be considerable potential for taxation by both the United States and France of the U.S.-source income of U.S. citizens residing in France. The potential for double taxation would be especially strong in the case of partners or partnerships which have U.S.-source income and retirees receiving pensions attributable to services performed in the United States. The protocol establishes a mechanism for the avoidance of double taxation of U.S.-source income. Generally, this is accomplished by French agreement to exempt part of the income from, or to give a partial credit against, its tax and U.S. agreement to treat part of the income as if from French sources, making French taxes on it eligible for the U.S. foreign tax credit.

General rules for avoidance of double taxation

The new rules affecting U.S. citizens resident in France modify more general rules for the avoidance of double taxation which are described below.

Business income

In the case of a U.S. resident subject to French tax on business income, the United States agrees to avoid double taxation through the foreign tax credit mechanism established under its domestic law. However, the United States is not precluded from amending its foreign tax credit rules without changing the general principle thereof.

France agrees to avoid double taxation of its residents subject to U.S. tax on business income by exempting from its tax any such income which is taxable by the United States under the treaty. This rule does not apply, however, if the French resident is a U.S. citizen and the income is taxable by the United States by reason of his citizenship. The exemption under this provision is "with progression." That is, although the French resident does not pay French tax on the income, the rate of French tax on his remaining income takes into account the excluded income. The Note accompanying the protocol gives the example of a French resident with $20,000 of income, $8,000 of which is exempt from French tax under the treaty. His French tax on the remaining $12,000 will be 60 percent ($12,000/$20,000) of the amount of French tax he would have paid on $20,000 of income.

Investment income

The United States avoids double taxation on the investment income (dividends, royalties, interest, and capital gains) of its residents through the foreign tax credit mechanism. France avoids double tax on investment income of its residents by allowing a credit against French tax for the U.S. tax imposed on the income. However, this rule does not apply if the French resident is a U.S. citizen and the income is taxable by the United States by reason of his citizenship.

Change in French domestic law

France generally taxes individuals who are French residents on their worldwide income, allowing a deduction, but not a credit, for foreign income taxes paid. A foreign tax credit is only allowed by France pursuant to a tax treaty. Prior to 1979, however, this general rule did not apply to U.S. citizens resident in France. Article 164–1 of the

French income tax law exempted from French tax foreign (to France) income of a French resident if that individual was subject to tax on his worldwide income by his country of citizenship. As a practical matter, this provision applied predominantly to U.S. citizens. In 1976, however, France generally revised its jurisdictional tax rules. As part of this revision, the protection of Article 164–1 was repealed, subjecting U.S. citizens resident in France to the same tax rules as applied to other foreign nationals resident in that country. The effective date of the repeal was, however, delayed to January 1, 1979.

France took the position that the provisions in the existing treaty for relief from double taxation were insufficient to prevent the imposition of French tax on U.S. citizens who were French residents.

Special rules for U.S. citizens resident in France

The proposed protocol mitigates the effect of the change in French law through a set of special rules designed generally to divide the revenue from U.S. citizens resident in France between the U.S. and French Treasuries. These rules are described below.

(*1*) *Partners*

Partnership income requires complex rules under the proposed protocol because of different rules for the treatment of that income under U.S. and French law. In general, under U.S. law, each partner is treated as receiving a pro rata share of the partnership's income, and each item of that income retains the same source and character in his hands as it had in the partnership's. For example, assume that a U.S. law partnership with 10 partners has an office in France. Each partner is entitled to an equal share of the partnership's income, and one of the partners is a U.S. citizen resident in France. The partnership earns $1,000,000, of which $150,000 is attributable to French sources and $850,000 is attributable to U.S. sources. Under U.S. law, each partner generally is treated as receiving $100,000 of income, of which $15,000 is from French sources and $85,000 is from U.S. sources.

There are two exceptions to this rule. First, if the partner's share of partnership income depends on the profits of a foreign branch of the partnership, rather than overall partnership income and loss (a "special allocation"), then his partnership income may be treated to that extent as from foreign, rather than domestic, sources. In that case, the partnership income of the other partners which is treated as from foreign sources is decreased, and their share from domestic sources is increased. Second, if a payment is made to a partner by the partnership for services without regard to partnership income (a "guaranteed payment"), that payment has its source where the services are performed. Thus, if a partner performing services abroad receives a $20,000 guaranteed payment, that entire amount is treated as from foreign sources. If this expense to the partnership is allocable to the partnership's foreign source income, then the foreign source income of the partners is reduced by a like amount, in proportion to their partnership shares.

France, on the other hand, treats all of a partner's income from the performance in France of services for a partnership as from French sources and subjects its residents to tax on that entire amount, providing no exemption or credit for U.S. tax on amounts which, under U.S. rules, would be treated as from U.S. sources. Moreover, if the profits of the French branch exceed the partnership income of the French resident partners, the remainder may be taxed to the partnership's non-French partners in proportion to their respective shares. Thus, in the previous example, the entire $100,000 partnership distributive share of the French partner would be treated by France as from French sources and fully taxable without exemption or credit. Moreover, since the French office earned $150,000, an additional $50,000 ($150,000 less $100,000) may be taxed to the remaining U.S. partners as French source income.

The possibility of double taxation of the French partner arises from these different source rules. In the case of the French partner, France taxes his partnership share in full. However, this tax may not be fully creditable against U.S. tax. A fundamental premise of the U.S. foreign tax credit is that it should not offset the U.S. tax on amounts which the United States considers to be U.S.-source income. Accordingly, the computation of the foreign tax credit contains a limitation to insure that the credit only offsets the U.S. tax on the taxpayer's foreign income.[3]

In the preceding example, the French partner had $15,000 of French source income and $85,000 of U.S. source income under U.S. rules. Assume that the French tax on the French partner's $100,000 of income is $45,000. Assume also that the partner's pre-credit U.S. tax on this amount is $50,000, and that the partner has no other income or foreign taxes. Since 15 percent ($15,000/$100,000) of the taxpayer's total worldwide income is from foreign sources, his foreign tax credit is limited to $7,500, or 15 percent of his $50,000 pre-credit U.S. tax. Thus, without the benefit of the protocol, he would pay $45,000 in income taxes to France and $42,500 ($50,000 pre-credit U.S. tax less $7,500 foreign tax credit) to the United States, or a total for both countries of $87,500. The taxpayer would be allowed to carry over to other years the $37,500 in French taxes for which he was not allowed a credit in the current year. However, these credits may not be usable in the other years and in any event do not relieve the burden of double taxation in the current year.[4]

At the same time, the partners resident in the United States may gain an unwarranted benefit from the difference between French and

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[3] The limitation operates by prorating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") between his U.S. and foreign source taxable income. Therefore, the limitation is determined by using a simple ratio of foreign source taxable income divided by total taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income and, thus, the upper limit on the foreign tax credit.

[4] Instead of electing to credit French taxes against his U.S. income tax liability, subject to the limitations on the credit discussed above, the French partner could deduct his French taxes paid from his U.S. income subject to tax. In that case, his taxable income from the partnership would be $55,000 ($100,000 less the $45,000 of French taxes paid). Assuming that his effective U.S. rate of tax on the income remains 50 percent, his U.S. tax liability would be $27,500 (50 percent of $55,000). His total income tax liability to France and the United States for the year would thus be $72,500 ($45,000 plus $27,500). This would be $15,000 less than the liability if he elected the foreign tax credit. However, he would have no excess tax credits to carry over to other years.

U.S. rules. In the above example, France, while taxing the French resident partner on $100,000 of the partnership's French income, would tax each of the remaining nine partners on only $5,556 ($50,000 divided by 9). However, the U.S. tax rules treat them each as having received $15,000 of foreign source income. Accordingly, they may be able to use this income (on which French tax would ordinarily be lower than their effective rate of U.S. tax on $15,000) to increase their allowable foreign tax credit limitation to obtain additional credits for foreign taxes paid on other income which is taxed at a rate higher than U.S. rates.

The proposed protocol deals with the potential for double taxation by prescribing special source rules for the income of partners. First, paragraph 3 of the protocol adds a new provision to Article 6 (*Business profits*) of the treaty. The new paragraph provides that each partner is treated as realizing his ratable share of partnership income and losses. That income is generally to be treated as having the same source and character in his hands as in the hands of the partnership, except to the extent that his share of the profits depends on the source of the income (i.e., a special allocation). This provision is a restatement of the U.S. rules for the source of partnership income and overrides the conflicting French rules. It does not apply to guaranteed payments.

By itself, this rule would exempt from French tax (under the general provisions for the avoidance of double taxation) all of the partner's distributive share treated as from U.S. sources under U.S. source rules because that amount would be taxable by the United States other than by reason of the U.S. citizenship of the partner. However, France was unwilling to go that far. Accordingly, the application of this rule is limited by paragraph 6 of the proposed protocol which adds a new provision to Article 14 (*Independent personal services*) of the treaty. This rule provides that the special partnership source rules of the proposed protocol may not result in the exemption from French tax (under the general provisions for avoidance of double taxation) of more than 50 percent of the earned income from a partnership of the U.S. citizen who is resident in France. For purposes of this limitation, the partner's "earned income" includes any guaranteed payments which he receives from the partnership for his services; so if, for example, he receives a $20,000 guaranteed payment and a $100,000 distributive share of profits, application of the proposed protocol's partnership source rules could not result in French exemption of more than $60,000 (50 percent of $120,000) of the distributive share of partnership income.

The proposed protocol further provides that if, solely because of the 50-percent limitation, not all of the U.S. source income of the partners who are U.S. citizens resident in France is exempt, the amount of partnership earned income from French sources on which France can tax the nonresident partners is to be reduced by the difference between the total U.S. source partnership income of the resident partners and the amount they are allowed to treat as exempt.

These rules may be illustrated by returning to the earlier example. Under the general rule in paragraph 3 of the protocol, the French resident partner would be allowed to treat $85,000 of his partnership distributive share as from U.S. sources and exempt from French tax. However, assuming that he receives no guaranteed payments, the amount he may exempt is limited by paragraph 6 to 50 percent of his $100,000 distributive share, or $50,000. Thus, he will still be subject to French tax on the remaining $50,000. However, France agrees not to tax the nonresident partners on the $35,000 difference between the resident partner's $85,000 of U.S. source income and the $50,000 he is allowed to exempt. Thus, each of the nonresident partners has $15,000 of French source income under the general source rule, reduced by $3,889 ($35,000 divided by 9) as a result of the special limitation, or $11,111 of income subject to French tax.

Thus, there is still a potential for double taxation, but that potential is reduced. The French resident partner is taxed by France on $50,000 (rather than $100,000) of income and is treated by the United States as having $15,000 in foreign source income for purposes of the foreign tax credit. His partners are taxed by France on $11,111 (rather than $5,889) of income and are treated by the United States as having $15,000 of foreign source income. This reduces the overall tax burden on the French resident partner (at the expense of the French Treasury). It increases the French tax on the nonresident partners. This, as a practical matter, is at the expense of the U.S. Treasury because these individuals will generally be allowed a U.S. foreign tax credit for the full amount of French tax paid.

The proposed protocol provides a further mechanism to bring the U.S. and French source rules into correspondence, but it requires the consent of the affected partnership. For any taxable year, the partnership may make an election under which the U.S.-source income of a partner resident in France which cannot be treated as exempt because of the proposed protocol's 50-percent limitation will be treated by the United States as though it were from French (rather than U.S.) sources, increasing the French partner's foreign tax credit limitation. At the same time, the partnership share of foreign source income of each of the other partners is correspondingly reduced. (The amount that they will be treated as receiving from domestic sources is correspondingly increased.)

The effect of this election may be illustrated by returning to the example. The French partner is taxed by France on $50,000 of income and is treated by the United States as having $50,000 ($15,000 plus $35,000), rather than $15,000, of foreign source income, increasing his foreign tax credit limitation. His partners are taxed by France on $11,111 of income and are treated by the United States as having $11,111 ($15,000, minus $35,000/9), rather than $15,000, in foreign source income. Thus, the U.S. and French rules are brought into correspondence.

This special rule is made elective for two reasons. First, although it is favorable to the French partner, it may have an unfavorable effect on the partners resident outside of France by reducing their U.S. foreign tax credit limitations. Second, the proposed protocol provides that, if the election is made, the partners resident in France are denied any benefits of the special exclusion or deduction (Code secs. 911 and 913) for Americans working abroad. It is possible that the French resident partners would prefer the benefits of these Code provisions to the additional relief provided under the protocol election. It was therefore believed that the question of whether the election should be made should be settled among the partners in accordance with their partnership agreement. Once the election is made, however, it is binding on all the partners, including those (if any) who opposed it.

(*2*) *Retirees*

Under the French system of worldwide taxation, France would tax all the pension income of U.S. citizens resident in France. The United States would treat as foreign source income the portion of the pension attributable to services performed outside the United States. (Rev. Rul. 72–149, 1972–1 C.B. 218.) However, the remainder would be treated as from U.S. sources. Thus, under the foreign tax credit limitation rules, it is likely, where part or all of the retiree's services were performed in the United States, that he would not receive a full credit against his U.S. tax liability for French taxes paid.

The proposed protocol prevents double taxation through France's agreement to exempt private pension income from French tax to the extent it is attributable to services performed while the retiree's principal place of employment was in the United States. Thus, France exempts the income attributable to services performed in the United States, while the United States gives a credit for French taxes on income attributable to services performed outside the United States.

(*3*) *Investment income*

The United States and France divide the tax revenues on investment income (dividends, interest, royalties, and capital gains) from U.S. sources of a U.S. citizen resident in France basically by treating him as though he were not a U.S. citizen (i.e., as though he were a nonresident alien). This is accomplished by each country allowing limited credits for the other's taxes on the income. However, if the allowable credit for French tax on the income is less than what the U.S. tax on these citizens would be, the United States may impose its tax on the difference.

The United States generally taxes nonresident aliens on dividends, interest and royalties not connected with a U.S. business of the alien by withholding at source a tax of 30 percent of the *gross* amount. This withholding tax generally satisfies the nonresident alien's U.S. tax liability on the income, and if he does not have other U.S. income he ordinarily need not file a tax return. The United States does not tax U.S.-source capital gains of a nonresident alien (i.e., the tax rate is zero) unless he is present in the United States more than a half year or the gains are connected with a U.S. business.

The 30-percent withholding rate is frequently reduced by treaty. Under the French treaty, the rate on dividends paid to individuals is 15 percent, the rate on interest is generally 10 percent, and the rate on royalties is 5 percent.

The proposed protocol provides that, when a U.S. citizen resident in France receives U.S.-source investment income, France will give a credit for the amount of tax the U.S. would have been allowed to collect had the recipient been a nonresident alien. For example, if the individual receives a $100 interest payment from U.S. sources (other than from a bank), France agrees to give a credit of $10 (10 percent of $100) against its tax on the income. Thus, France, through the credit, gives the United States the first opportunity to tax the income on the basis of its source.

Because the income is U.S. source, the U.S. foreign tax credit limitation would ordinarily prevent a credit against U.S. tax for any remaining French tax on the income (after the French credit for $10). However, under the protocol, the United States gives France the next opportunity to tax the income by agreeing to treat part of the income as from French sources, increasing the recipient's foreign tax credit limitation, and thereby, as a practical matter, allowing French tax on the income to be credited against the individual's U.S. tax liability.

The portion of the income which will continue to be treated as U.S. source is determined by a fraction. The numerator of the fraction is the rate of tax at which the United States could tax the income if the recipient were not a citizen (the same rate at which France agrees to give a credit against its tax under the previous step). The denominator is the effective rate of U.S. tax (before reduction by the foreign tax credit and the investment tax credit) on the individual's *gross* income. The difference between the total amount of the investment income and the part which retains its character as U.S.-source income is treated as French-source income.

This rule may be illustrated by an example. Suppose a U.S. citizen resident in France has $100,000 in gross earned income and business deductions of $20,000. He also receives $5,000 in U.S. dividend income. His gross income is $105,000 ($100,000 plus $5,000) and his taxable income is $85,000 ($105,000 less $20,000). Assume that his pre-credit U.S. tax on this income is $42,000. The portion of investment income which will be treated as U.S.-source is a fraction the numerator of which is 15 percent, the rate of tax the U.S. may impose under the treaty on U.S.-source dividend income of French residents who are not U.S. citizens. The denominator is 40 percent, the effective rate of tax on his *gross* income ($42,000/$105,000). Thus, the amount of the dividend treated as U.S. source is $1,875 ($5,000 times 15/40). The remaining $3,125 is treated as if it were from French sources. However, the protocol prevents abuse of this rule by providing that it applies only to the extent that the item of income is included in the taxpayer's income for purposes of determining his French tax.

Finally, the United States, after conceding (through the U.S. foreign tax credit mechanism) the priority of France's right to impose a tax based on residence, reserves the right to impose its tax based on the citizenship of the taxpayer. In the foregoing example, the pre-credit U.S. tax on the $5,000 of dividend income is $2,471 ($5,000 of taxable income multiplied by the effective pre-credit tax rate on *taxable* income of $42,000/$85,000). The maximum credit which the United States will allow for French tax on this income is $1,544 ($2,471 multiplied by $3,125/$5,000). Thus, if the full credit is allowed, the United States will collect a tax of $927 ($2,471 less $1,544) on this income. Of this amount, $750 (15 percent of $5,000) is collected by virtue of the source of the income. The additional $177 ($927 less $750) is collected by virtue of the U.S. citizenship of the taxpayer.[5]

[5] The taxpayer's creditable foreign taxes and his foreign tax credit limitation are computed on the basis of his total worldwide income, not on the basis of each item of income, as in the foregoing example. Accordingly, the taxpayer may in a particular case pay more or less U.S. tax than the amount shown. However, the example helps to illustrate the extent to which double taxation is avoided under the protocol.

(4) Other special rules

France also agrees to exempt from its tax income of U.S. citizens who are resident in France to the extent that the income is for services performed (independently or as an employee) in the United States, if certain conditions (spelled out in the treaty) are met. The United States treats this income as U.S. source, which would lead to double taxation in the absence of the exemption from French tax provided in the protocol.

Similarly, France agrees to exempt from tax the income of a U.S. citizen who is a resident of France from certain services performed in the U.S. as a teacher, or as a student or trainee. This income would be exempt from U.S. tax if earned by a French resident who is not a U.S. citizen, but is subject to U.S. tax when earned by a U.S. citizen.

The Note accompanying the proposed protocol spells out the proper treatment under French tax law of contributions to, and distributions from, pension plans, stock options, and U.S. state and local income taxes. The Note also provides that France will attempt to reach a reasonable solution concerning the treatment of employer-provided benefits which are not taxable by the United States (such as certain group life and medical insurance benefits).

The Note also provides that the Explanatory Note issued by the U.S. and French governments (Treasury Department News Release WS 1190 (Nov. 29, 1976)) shortly after France amended its law to tax U.S. citizens resident in France on their worldwide income will cease to have effect for periods to which the proposed protocol applies. The Explanatory Note prescribed an interim arrangement for avoidance of double taxation.

French tax based on use of a residence

Under French law, an individual who is not domiciled in France, and who therefore is not subject to the regular French tax rules, is nevertheless generally subject to French tax if he has the use of an abode in France. The tax base, to which regular French tax rates apply, is three times the rental value of the abode. The proposed protocol continues the rule in effect under the existing treaty that this tax does not apply to a U.S. resident.

Article 2. Entry into force

Article 2 of the proposed protocol provides that it will enter into force one month after instruments of ratification are exchanged and will be retroactively effective with respect to taxable years beginning on or after January 1, 1979. This effective date corresponds with the effective date of the new French law taxing U.S. citizens resident in France on their worldwide income.

Article 3. Termination

Article 3 of the proposed protocol provides that it will remain in force as long as the U.S.-French income tax treaty remains in force.

Exchange of Notes

In an exchange of Notes accompanying the signing of the proposed protocol, various points regarding the avoidance of double taxation under the protocol were clarified, as is explained in the discussion above of paragraph 10 of Article 1 of the proposed protocol (*Avoidance of double taxation*).

The Note also states the positions of the two governments on two issues which were not resolved in the protocol.

French avoir fiscal

Under the French system of integrated corporation taxation, French residents who receive a dividend from a French corporation are treated as having paid part of the corporate income tax which was imposed on the corporate income from which the dividend was paid. They are allowed to credit this amount (*avoir fiscal*) against their personal income tax liability. French law does not allow this credit to nonresident shareholders. However, the first protocol (signed in 1970) to the French treaty extends similar treatment to portfolio shareholders (corporations owning less than 10 percent of the French corporation's stock and individuals and other noncorporate shareholders) who are U.S. residents. U.S. direct investors (corporations owning 10 percent or more of the French corporation's stock) are still excluded.

The United States took the position that the denial of the French *avoir fiscal* to U.S. direct investors was unfair discrimination. In recognition of France's revenue concerns, however, the U.S. negotiators were prepared to accept a refund to direct investors of one-half the credit available to French shareholders, minus the 5-percent withholding tax allowed under the treaty on dividend payments to direct investors. This would be similar to the arrangement in the proposed income tax treaty between the United States and the United Kingdom for refund to U.S. direct investors of the U.K. Advance Corporation Tax (ACT). France agreed to reopen discussions on this subject as soon as possible and in any event if the credit for the *avoir fiscal* is extended in full or in part to direct investors of other countries.

State taxation

Some states of the United States (particularly, California, Oregon, and Alaska), in determining the amount of income of a business operating within the state which is to be apportioned to that state for income tax purposes, require combined reporting of all related business operations (including related business operations of affiliated U.S. and foreign corporations, whether or not doing business within the state). France took the position that for a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a state of the United States, in English, imposes a costly burden.

The United States negotiated, as part of the proposed U.S.-U.K. income tax treaty, a provision which would have restricted the ability of states to use this worldwide combination/unitary method of apportionment. However, when the U.S. Senate gave its advice and consent to the ratification of the treaty, it did so with a reservation that nullified this provision as it applied to the states. As a result, certain terms of the proposed U.S.-U.K. treaty had to be renegotiated in a proposed protocol. France understood this, but continued to be concerned about the issue as it affects French multinationals. The United States agreed to reopen discussions with France on this subject if an acceptable provision can be devised.

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