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Stephanie H. Simonard

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The Newly Revised Income Tax Treaty With France: A Breakthrough In U.S. Tax Treaty Law

*Stephanie H. Simonard**

In 1979, the United States and France revised their 1967 Income Tax Treaty. Developed along the lines of the Organization of Economic Co-Operation and Development Model Convention, the revised Treaty adopts a unique method of calculating the U.S. foreign tax credit limitation. The revised Treaty changed the definition of "source" of income to permit the foreign tax credit against what would otherwise be termed "U.S. source income." In this article, Mrs. Simonard examines the revised Treaty and its effects on U.S. citizens residing in France.

A major change in French tax law¹ in 1976 caused many Americans to leave France and pushed the United States Treasury Department to renegotiate the 1967 Income Tax Treaty between France and the United States.² The result of the negotiations is a revised treaty that is unique in that it approximates the spirit of the Organization for Economic Co-Operation and Development (OECD) Model Convention³ more than any other U.S. tax treaty with respect to the taxation of individuals. It is also the only U.S. treaty that provides a major deviation from the Internal Revenue Code (I.R.C.) for U.S. citizens.⁴

* Manager, Tax Department, Peat, Marwick, Mitchell & Co., Paris, France; A.B., 1972, Sweet Briar College; *Certificat à titre étranger* from l'Institut d'Études Politiques, Paris, France.

¹ See notes 4-6 and accompanying text *infra*.

² Convention Between the United States of America and the French Republic With Respect to Taxes on Income and Property, July 28, 1967, 19 U.S.T. 5280, T.I.A.S. No. 6518.

³ Organization for Economic Co-Operation and Development Model Convention for the Avoidance of Double Taxation With Respect to Taxes on Income and Capital, [1980] 1 TAX TREATIES (CCH) ¶ 151 [hereinafter cited as OECD Model].

⁴ U.S. treaties with Belgium and Japan do provide limited sourcing rules with respect to compensation. The Belgian Treaty provides that "[i]ncome which has been taxed by Belgium in

While the I.R.C. taxes U.S. citizens on their worldwide income regardless of their residence, the revised Treaty equates U.S. citizens residing in France with French citizens who are not U.S. residents. Thus, the Treaty recognizes France's right to tax worldwide income, including most types of U.S. source investment income. To achieve this treatment, however, the individual U.S. taxpayer residing in France faces a complex tax situation. This article will focus on the changes, the unique aspects of the revised Treaty, the differing U.S. and French interpretations of the Treaty, and the practical problems that have arisen in its application from the perspective of an American citizen residing in France.

TAX REVERSAL FOR U.S. CITIZENS RESIDING IN FRANCE

Following World War II and up through 1978, France was a tax haven for numerous American citizens. France taxed its residents on a worldwide income basis; American citizens were exempt from French tax on U.S. source investment income (and in some cases on part of their compensation income) because of Article 164-1, which provided an exemption to individuals subjected to tax on worldwide income by their country of origin.⁵

At the end of 1976, in a major revision of the definitions of "domicile" and "residence," and of the taxation of French citizens sent overseas on business assignments, the French National Assembly repealed Article 164-1.⁶ There was no publicity about this aspect of an other-

accordance with Articles 6 through 21 shall, for the purpose of applying the United States credit in relation to Belgian tax, be treated as income from Belgian sources." Convention Between the United States and Belg. for the Avoidance of Double Taxation, July 9, 1970, art. 23(2), 23 U.S.T. 2689, 2706, T.I.A.S. No. 7463. In practice, however, this provision has not had wide application. See also Convention Between the United States of America and Japan for the Avoidance of Double Taxation, Mar. 8, 1971, 23 U.S.T. 967, T.I.A.S. No. 7365. Also, most treaties have foreign tax credit provisions applicable to U.S. citizens despite a "savings clause." Even these provisions, however, can be rendered inapplicable. See Rev. Rul. 79-152, 1979-1 C.B. 237; Rev. Rul. 80-201, 1980-30 I.R.B. 15; Rev. Rul. 80-223, 1980-33 I.R.B. 12.

⁵ [1969] CODE GÉNÉRAL DES IMPÔTS, art. 164-1 (France). Article 164-1 specifically stated: "Taxpayers of foreign citizenship who are domiciled in France are taxable. . . . However an exemption from this taxable income will apply to foreign source income to the extent that the taxpayers can show that they were subjected to tax in their country of origin on their worldwide income." Since the United States is the only major Western country which taxes its citizens who are resident abroad on their worldwide income, this provision was utilized in fact by Americans.

⁶ Law N° 76-1234 of December 29, 1976, [1979] CODE GÉNÉRAL DES IMPÔTS, art. 164. In fact, under this law, a person may be either a "domiciliary" or a "non-resident" but not a "resident" of France, for tax purposes. To be considered domiciled, it is sufficient to live or work in France, have major economic or family ties with France, or spend over six months there. Under this broad French definition, the term "domiciliary" in fact corresponds to the U.S. tax definitions of both "resident" and "domiciliary." In this article, the treaty term "resident" is used through-

wise highly-touted bill and Americans were able, *in extremis*, to postpone the applicable provisions until 1979, and to promote the renegotiation of the Income Tax Treaty between France and the United States.⁷

Indeed, an amendment to the Treaty was necessary. Double taxation of U.S. source income would result from the new French law for Americans residing in France; the foreign tax credit provisions of the U.S. Internal Revenue Code⁸ would not provide effective relief. Almost three years later, the Protocol of November 24, 1978 (date of signature) was ratified on September 27, 1979, retroactively effective from January 1, 1979.⁹

The Treaty, as amended by the Protocol,¹⁰ has been criticized as inequitable, but the result did meet the objective of avoiding double taxation. In the negotiations leading up to the final Protocol, the French were in a position of strength: there was no particular justification for maintaining the Article 164-1 exemption, and principles of international law clearly recognize the right of a host country to tax the worldwide income of its residents. This is a basic premise of both the OECD Model Convention,¹¹ as well as the U.S. Treasury Department's own Model Convention.¹²

UNIQUE PROVISIONS COMBINE TO PROVIDE MODEL RESULT

The originality of the Protocol is the relief from double taxation under Article 23,¹³ and specifically the calculation of the U.S. foreign tax credit, which is a dollar-for-dollar reduction in U.S. income tax for

out, to denote that the U.S. citizen is a resident of France under French Code Général des Impôts Article 4B, and under Article 3(1) of the 1967 Income Tax Treaty between France and the United States, note 2 *supra*.

⁷ Law N° 76-1234 of December 29, 1976, was effective beginning January 1, 1977, except as applicable to persons taxed in their country of origin on a global basis—ie, U.S. citizens—the effective date being January 1, 1979. *Id.* art. 164-1.

⁸ I.R.C. §§ 901-905.

⁹ Protocol to the Convention Between the United States of America and the French Republic With Respect to Taxes on Income and Property of July 28, 1967, as amended by the Protocol of Oct. 12, 1970, Nov. 24, 1978, — U.S.T. —, T.I.A.S. No. 9500, [1980] 1 TAX TREATIES (CCH) ¶ 2836A [hereinafter cited as Protocol]. The Protocol “entered into force” one month after ratification, on October 27, 1979. Hereafter, the term “Protocol” refers to the Protocol of November 24, 1978.

¹⁰ All further textual citations to the Treaty refer to the Convention Between the United States and France With Respect to Taxes of July 28, 1967, as amended by the Protocol of Nov. 24, 1978, [1980] 1 TAX TREATIES (CCH) ¶¶ 2803-2835 [hereinafter cited as French Treaty].

¹¹ OECD Model, note 3 *supra*.

¹² Treasury Department's Model Income Tax Treaty of May 17, 1977, [1980] 1 TAX TREATIES (CCH) ¶153 [hereinafter cited as Treasury Model].

¹³ Protocol, *supra* note 9, at art. 23.

the *allowable amount* of foreign income tax incurred.¹⁴ The key concept here is not the total amount of foreign tax, but rather the calculation of the "allowable amount," known as the foreign tax credit limitation.

The Foreign Tax Credit and Source Rules

Essentially, American citizens are taxed on their worldwide income, regardless of their place of residence. They utilize the same tax forms, define their income the same way, and are audited by the Internal Revenue Service, which has offices overseas. The principal difference in the calculation of the U.S. taxable income applicable to non-resident Americans, is certain deductions designed to offset part of the higher expenses incurred by salaried or self-employed individuals living abroad.¹⁵ Recognizing that foreign countries also will attempt to tax Americans residing abroad on at least a portion of their earnings, U.S. law provides a foreign tax credit.¹⁶ This credit is a direct reduction of tax, similar to the investment tax credit.

The foreign tax credit has been in existence since 1918, and has been a useful tool in avoiding international double taxation of U.S. citizens. It only permits, however, a credit of foreign taxes paid or accrued against the U.S. tax on foreign source taxable income.¹⁷ For example, if an individual has \$1000 of U.S. tax liability, and 75% of his income is from foreign sources, a limitation of \$750 (75% of the U.S. tax) is imposed on the amount of actual foreign tax which will be permitted as a reduction of the U.S. tax. If the individual has paid \$500 in French taxes, his U.S. credit would be \$500; but if he paid \$800, his credit would be \$750.¹⁸

A treaty negotiator can hardly tamper with a provision of the I.R.C. that has been in existence for sixty years, and expect approval by the U.S. Senate. Instead, the language of the Treaty changed the definition of "source of income," to permit the foreign tax credit against what would otherwise be termed "U.S. source income." To fully un-

¹⁴ *Id.* at art. 23(1).

¹⁵ I.R.C. §§ 911 (exclusions from income), 913 (deductions from income).

¹⁶ *Id.* at §§ 901-905.

¹⁷ *Id.* at § 904.

¹⁸ *Id.* at §§ 901-905. Under § 904(c), the U.S. tax can be reduced to zero. Any excess foreign tax can be carried back for use two years prior to the year in question, or carried forward for use five years afterward. *Id.*

The author has provided only the general concept of the foreign tax credit. The intricacies of its computation plus the definitional aspects are admirably discussed in E. OWENS, *THE FOREIGN TAX CREDIT* (1961).

derstand the importance of this innovation, a review of the concept of "source" is necessary.

The OECD Model Convention does not use the word "source," and although the official commentary concerning the Model uses the word frequently, "source" is not specifically defined. Nor is the term "source" defined in the U.S.-French treaty, but Article 2(2) states that "any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of the contracting state relating to the taxes which are the subject of the convention."¹⁹ The I.R.C. provides sourcing definitions or rules in sections 643, 861-864, 956 and 2104.²⁰

Voluminous Treasury regulations also are devoted to the definition of "source," but for the typical American citizen residing overseas, U.S. source income includes: dividends and interest from U.S. corporate securities; interest from a U.S. bank or other U.S. debt obligations; compensation received for services rendered in the U.S. (including an allocation of earnings to business trips to the United States); income from property or royalties located in the United States; capital gains on security sales (unless the securities were sold in the country of foreign residence or a minimum foreign tax of 10% was paid in the country of sale); and capital gains on the sale of real property located in the U.S.²¹ Trust income is treated according to the source of its elements, and the source of business income is defined as the country in which the business effectively operates.²² Income may be categorized as U.S. source, foreign source, or both.²³

French internal law is less detailed in this respect because it allows a foreign tax credit only within the context of a treaty provision, with no internal tax equivalent. But for the purposes of taxing U.S. citizens residing in France, the U.S. approach is generally acceptable to France.

New Source Rules Under Treaty

Under the revised Treaty, the U.S. source rules are vastly altered

¹⁹ French Treaty, *supra* note 10, at art. 2(2). In Herbert A. Filler, 74 T.C. — (1980), No. 28, [1980] TAX CT. REP. DEC. (P-H) ¶74.28, this article was used—or in the writer's view, abused—by not properly discussing the context of the Treaty in defining the "source" of earnings resulting from a business trip to the U.S. by an American living in France. This particular definitional problem has been resolved by the new Protocol.

²⁰ I.R.C. §§ 643, 861-864, 956 and 2104.

²¹ *Id.* at § 861.

²² I.R.C. § 652(b) ("conduit rule"). See also I.R.C. §§ 661(b), 662(b).

²³ *Id.* at §§ 862-863.

with respect to income derived from the U.S. that is taxable in both countries. Hence, generally:

1. If a U.S. dividend is taxable in France, enough of that dividend will be treated as U.S. source to ensure a U.S. tax of 15% on it; the remainder will be treated as French source;²⁴
2. Similarly for U.S. interest and royalties, except that the U.S. tax will amount to 10%, and zero or 5% respectively;²⁵
3. U.S. capital gains taxed in France become fully French source;²⁶
4. Up to 50% of U.S. earned income from partnerships could become French source if an election provided in the Treaty is made by the partnership.²⁷

Items 1-3 equate the U.S. citizen with a French citizen (except where the overall tax before foreign tax credit exceeds that in France, as explained below).²⁸ Item 4 was a compromise between France and the United States.

ANALYSIS OF THE PROTOCOL PROVISIONS

The provisions (or absence thereof) of the Protocol relevant to the U.S. citizen residing in France concern income from the performance of services, pensions, earned partnership income, alimony and those provisions dealing with passive investment income including dividends, interest, royalties and capital gains. It is important to remember that the relief from double taxation in this Treaty lies in the definition of *source* in the context of the calculation of the foreign tax credit in the U.S. return.

Compensation for Services Rendered

The U.S. upheld one traditional U.S. source item by providing that income allocable to business trips to the United States be treated as U.S. source income. This conforms to U.S. tax law and ends a long-standing *de facto* item of double taxation,²⁹ but differs from the recent Belgian-U.S. tax treaty where income related to such trips is converted to Belgian source, if subject to tax in Belgium.³⁰ Under both U.S. and French tax laws, the individual's total compensation should now be

²⁴ French Treaty, *supra* note 10, at art. 9.

²⁵ *Id.* at arts. 10-11.

²⁶ *Id.* at art. 12.

²⁷ *Id.* at art. 23(3)(c)(i).

²⁸ See notes 76-91 and accompanying text *infra*.

²⁹ See Filler, 74 T.C. — (1980).

³⁰ Belgian Treaty, note 4 *supra*.

partially allocated to days spent in the U.S. on business.³¹ As a practical matter this is usually accomplished by multiplying total compensation by a ratio of days worked in the United States, to total days worked during the year.³² Since "total compensation" may be defined differently under U.S. and French tax rules, the resulting figure may not be identical on the U.S. and French tax returns of the same individual.

This allocation of income to U.S. business trips applies only to U.S. citizens residing in France and cannot be applied to French citizens.³³ This is different from the treatment of U.S. and French citizens under the Treaty: Article 15 provides that a French resident (other than a U.S. citizen) may spend up to 183 days per year in the U.S. on business without incurring income tax there, to the extent that the payment for services is not made or borne by an employer or permanent establishment in the U.S.³⁴ Thus, a business trip to the U.S. may be taxable only in the U.S. for a U.S. citizen, but taxable only in France for a French citizen.

An Exchange of Letters between the U.S. and France accompanied the Protocol to discuss various additional items not specifically covered in the Protocol itself.³⁵ Among the items included are the French tax treatment of employee stock options and contribution to qualified pension, profit-sharing and other retirement plans by employers and self-employed taxpayers.³⁶ These letters basically concluded that the French treatment would conform to the U.S. treatment of these items. Thus, for example, the ordinary income element from stock options would be treated as taxable compensation in France.³⁷

³¹ French Treaty, *supra* note 10, at art. 23(2)(a)(ii).

³² French Instruction of February 19, 1980, para. II(3)(a), BULLETIN OFFICIEL DE LA DIRECTION GÉNÉRALE DES IMPÔTS No. 37 (Feb. 26, 1980) [hereinafter cited as Instruction].

³³ French Treaty, *supra* note 10, at art. 23(2)(a)(ii)(a).

³⁴ *Id.* at art. 15(2).

³⁵ Letters Attached to the Protocol of Nov. 24, 1978, [1980] 1 TAX TREATIES (CCH) ¶ 2836A (signed by Francois de Laboulaye, Ambassador of France, and George S. Vest, Assistant Secretary for European Affairs).

³⁶ *Id.* at paras. 3(a), 3(c). Additionally, para. 3(d) permits a deduction from French income which has been taxed for U.S. state and local income taxes on personal service and business income.

³⁷ *Id.* at para. 3(c). A practical question arises with respect to how much of the ordinary income is taxable in France if it could be argued that the ordinary income portion was earned over several years, most of which were not spent in France. For example, if an individual has a U.S. non-qualified stock option which he received while working in the United States and which he exercised in his first year of residence in France after having held the stock option for several years, does France have the right to tax the entire amount of ordinary income arising therefrom? If it does, would the United States treat the entire ordinary income portion as foreign source income? This matter is yet to be resolved, but it would appear that a reasonable solution would be

Pensions

Exemption from French taxation continues for U.S. social security or U.S. government pensions under Articles 16 and 20.³⁸ Important changes have occurred in the U.S. taxation of French social security and the joint taxation of private pensions.

Social Security. The Treaty Protocol removes an inequity in the treaty which permitted exemption of French social security pensions received by U.S. citizens if they resided in the United States, but no exemption if they resided in France. Article 20 now permits exemption from U.S. tax of French social security pensions no matter where the recipient resides. The application of this article is not affected by the "savings clause."³⁹

It should be noted, however, that no specific definition of "social security" is provided in any of the documents accompanying the Protocol. A reasonable assumption is that the definition includes pensions received from regular or executive pension plans where contributions were obligatory under French tax law.⁴⁰

Private Pensions. Private pensions received as a result of past employment (described in Article 19), are taxable in France except to the extent that the services rendered for such pensions occurred "when the principal place of employment was in the United States."⁴¹ Problems may arise in calculating the amount of exempt pension income. It appears, however, that the I.R.S. will accept the "source" definition provided in the French Administrative Instruction of February 19, 1980,⁴² which calculates the excludable amount as follows: if the activity was performed in the U.S. for more than half the year, the pension relating to the entire year is exempt in France; if the activity was engaged in for less than half the year in the U.S., the pension relating to the entire year would be taxable in France. The fraction of the total number of years worked in the U.S., over the total number of years worked to earn the pension, would be applied to the annual pension to determine the

a split between countries, similar to the treatment of pension income, as discussed at the text accompanying notes 40-44 *infra*.

³⁸ French Treaty, *supra* note 10, at arts. 16, 20.

³⁹ *Id.* at art. 22(4)(a)(i).

⁴⁰ A private letter ruling to the American Chamber of Commerce of France, Inc., from J.F. Ryals of the Internal Revenue Service, dated April 30, 1974, includes contributions to these plans as creditable foreign income taxes under a general definition of social security contributions.

⁴¹ French Treaty, *supra* note 10, at art. 23(2)(a)(ii)(c).

⁴² View expressed by Carolyn Christiansen of the I.R.S. in an oral presentation given at a meeting sponsored by the Assn. of Americans Resident Overseas (Mar. 7, 1980) Paris, France.

amount excludable from French taxable income.⁴³ This appears to conflict with the sourcing rules set forth in a recently published I.R.S. Revenue Ruling where, in a non-treaty situation, all of the capital appreciation element of the pension was treated as U.S. source income.⁴⁴

Finally, it should be noted in this respect that work must have been performed in the U.S. for the exemption to be applicable. Hence, if an individual performed work in other foreign countries, the pension relating thereto will be taxable in France; but the retired businessman who spent his entire working life in the United States may still retire to France and pay no tax there if his only income is from a private pension, U.S. social security and/or a U.S. government pension.

Professional Partnerships

Both during and after the negotiations, there was considerable debate over how the countries should share the tax imposed on the partnership income of a U.S. citizen residing in France, when the partnership's main activities are located in the United States. The partnership provisions in the Protocol are subject to various interpretations.⁴⁵

The compromise between France and the U.S. on the taxation of personal service income from partnerships resulted in another unique provision which changes the source of income in the U.S. return and concedes France's right to tax partially U.S. source income. A treaty provision was necessary because of a conflict in the two countries' tax rules for determining the source of partnership income related to personal services. Generally, a partner's share of partnership earnings is considered under U.S. law to retain the source and character which that income has within the partnership.⁴⁶ In other words, the source is determined at the partnership level. The major exception to this rule, covering guaranteed payments, is explained in detail below.⁴⁷ The French position apparently is that a French resident partner who receives his partnership share for the performance of services in France is considered to have received entirely French source income.⁴⁸ Thus

⁴³ Instruction, *supra* note 32, at para. II(2)(e).

⁴⁴ Rev. Rul. 79-389, 1979-2 C.B. 281.

⁴⁵ French Treaty, *supra* note 9, at arts. 6(4), 14(4), 23(3)(c).

⁴⁶ See I.R.C. § 702(b).

⁴⁷ See notes 58-63 and accompanying text *infra*.

⁴⁸ See SENATE FOREIGN RELATIONS COMM., S. EXEC. REP. NO. 96-4, 96th Cong., 1st Sess., REPORT ON THE PROTOCOL TO THE CONVENTION WITH FRANCE ON INCOME TAXES SIGNED NOVEMBER 24, 1979, Part VII, art. 1, para. 10 (1979); [1979] CODE GÉNÉRAL DES IMPÔTS, art. 164 B-I(d).

France argued that the entire amount of a U.S. resident partner's income was French source to him even though it conceded that the partnership may have had no French source income. The compromise confirms the U.S. rule in Article 6(4) whereby France agrees that source is determined at the partnership level;⁴⁹ but the U.S. then conceded in Article 14(4) the right of France in any event to limit the excluded income to 50% of the total.⁵⁰ A possible anomaly is that a French citizen partner may, under the new Treaty, exclude his entire share of U.S. source income from the partnership because Article 14(4) only refers to U.S. citizens. This results in a conflict with Article 24, Nondiscrimination.

If no guaranteed payment exists,⁵¹ and more than half of the partnership income is from U.S. sources, then the "50% minimum" provision would result in double taxation since France would be taxing U.S. source income. Accordingly, the Treaty provides relief through an election which may be made by the partnership to treat as foreign source income any income taxed in France because of the 50% provision.⁵² A condition of making the election is that the partner benefiting from it may not claim deductions under I.R.C. section 913.⁵³ The election also requires that in the partnership's U.S. return, the global foreign source income be reduced by the amount that is attributed to the partners residing in France under the election.⁵⁴ Procedures for making the election are provided in Revenue Procedure 80-16.⁵⁵ Any income taxed in France under the "50% provision" will reduce income taxable in France for non-resident partners.⁵⁶

Another potential area for concern is that many American partners residing overseas have been paid part of their partnership earnings in the form of "guaranteed payments" for services rendered overseas. Under U.S. law, these are considered to be foreign source on a similar basis as salary, and in the past have enabled partners to claim both foreign earned income deductions/exclusions and the foreign tax credit even if the partnership did not have net foreign source profits.⁵⁷

The published U.S. and French interpretations on the treatment to

⁴⁹ French Treaty, *supra* note 10, at art. 6(4).

⁵⁰ *Id.* at art. 14(4).

⁵¹ See notes 57-62 and accompanying text *infra*.

⁵² French Treaty, *supra* note 10, at art. 23(3)(c)(i).

⁵³ *Id.* at art. 23(3)(c)(ii).

⁵⁴ *Id.*

⁵⁵ Rev. Proc. 80-16, 1980-17 I.R.B. 29; I.R.C. §§ 911, 913. Section 911 does not currently apply to France, however, since it is not listed as a hardship area.

⁵⁶ French Treaty, *supra* note 10, at art. 14(4).

⁵⁷ Andrew O. Miller, Jr. v. Comm'r, 52 T.C. 752 (1969).

be accorded a guaranteed payment (although not discussed in the Protocol itself) are markedly different. The French Instruction of February 19, 1980, together with subsequent oral clarification, specifically make reference to these payments; the French seem inclined to consider them as though the payments were salary to the partner from the partnership, taxable in France under Article 15. The French ruling did *not* permit the exclusion provided in Article 14 on such payments.⁵⁸ Hence, in a case where a partner receives a guaranteed payment plus other partnership earnings from U.S. sources, the implication was that he would be taxed in France on 100% of the guaranteed payment plus 50% of the additional partnership earnings.

A literal reading of the Treaty would, however, lead to the conclusion that the 50% limitation applies to total income from the partnership, including the guaranteed payment. Article 14(4) states that the amount of income exempt from French tax under Article 6(4) will be limited to 50% of "total earned income from the partnership."⁵⁹ This wording is intended to ensure that France is allowed to tax at least one-half of a partner's income; there seems to be no reason why this should be changed if a partner receives a guaranteed payment.⁶⁰ For example, if a partner receives a guaranteed payment of \$75,000, and a distributive share of U.S. source income of \$125,000, his income taxable in France should be \$100,000, applying the 50% to the total partnership income of \$200,000. Apparently, the French may not agree with this interpretation.

If the foregoing analysis is correct, guaranteed payments could be used to obtain foreign source income in the U.S. return and avoid the need for an election under Article 23 (discussed below).⁶¹ In such a case, the partner would be able to claim on his U.S. tax return the foreign earned income deductions provided under I.R.C. section 913.

Finally, it should be noted that the stated French position on guaranteed payments, set forth above, is understood to be under review by

⁵⁸ Instruction, *supra* note 32, at paras. I(6), II(2)(c).

⁵⁹ French Treaty, *supra* note 10, at art. 14(4).

⁶⁰ SENATE FOREIGN RELATIONS COMM., ON THE PROTOCOL TO THE CONVENTION WITH FRANCE ON INCOME TAXES, S. EXEC. REP. NO. 96-4, 96th Cong., 1st Sess. (1979). Part VII, art. 1, para. 10 specifically states:

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.

Id. at 14.

⁶¹ See notes 73-75 and accompanying text *infra*.

the French Administration. Indications are that France may ultimately accept that only 50% of total income (including guarantees) will be taxed in France as long as at least 50% of total partnership income is from U.S. sources.⁶²

Alimony and Annuities

It appears that a drafting omission occurred in the Treaty, resulting in the potential double taxation of alimony and annuity income. France is given the right to tax these items received by a resident of France.⁶³ If the taxpayer is residing in the United States, however, U.S. law considers them to be U.S. source.⁶⁴ Since no special provisions are provided in the Treaty, double taxation could result. It appears that the tax on the alimony or annuity income should be given to France, with the United States granting a credit for that tax. To obtain this, however, the competent authority procedures would have to be invoked.⁶⁵ Curiously, the same problem would appear to arise from the Treasury's Model Convention.⁶⁶

Passive Investment Income

The taxation by France of passive U.S. investment income comes as the hardest blow to many Americans residing in France. Specifically, as stated above, dividends, interest, royalties and capital gains from U.S. sources were previously not taxed in France if they were taxed in the U.S.⁶⁷ Although many Americans remain unscathed, whole segments of the American community have been compelled by higher taxes either to leave France or to restructure their investment portfolios. Retired Americans or American spouses of foreigners who previously may have had no income taxable by France, were particularly hard hit. In many individual cases, although double taxation has been avoided under the terms of the Protocol, the worldwide tax is nevertheless doubled due to the effect of progressive tax rates.

⁶² This indication was derived from a meeting held by Mr. Baconnier of the Legislation Department of the Budget Ministry with various representatives of the public, including Mr. James Shaw of Peat, Marwick, Mitchell & Co. on November 25, 1980.

⁶³ French Treaty, *supra* note 10, at art. 19(2).

⁶⁴ Walter A. Howkins v. Comm'r, 49 T.C. 689 (1968).

⁶⁵ French Treaty, *supra* note 10, at art. 25(2).

⁶⁶ Treasury Model, note 9 *supra*. Treasury Model Article 18(3) grants exemption from U.S. tax in a similar situation. Yet Article 1(3), the savings clause, negates this. Furthermore, Article 23(3)(d) does not permit the alimony to be treated as foreign source (it should be noted that, at least as reproduced in CCH, Tax Treaties, Article 23(3)(d) erroneously refers to the savings clause as Article 1(2) when in fact it is Article 1(3)).

⁶⁷ See note 5 and accompanying text *supra*.

For example, a wife of a French citizen may have previously paid little or no tax on U.S. source investment income because it was taxed only in her separate U.S. return at the beginning marginal rates. Now, French law requires her income to be included in her husband's French return at much higher marginal tax rates of up to 60%, while as explained below,⁶⁸ only a relatively small credit is given for the U.S. tax which is deemed to equal the withholding tax rate provided in the Treaty or less if less U.S. tax is actually paid.⁶⁹ In fact, even if income is exempt from French tax under the Treaty, it may be used to push up the tax rate on income that is taxable in France.⁷⁰ The result is that while income subject to French taxes has increased, the number of Americans paying French tax has probably decreased.

As stated earlier, France had for years been a relative tax haven for these individuals. In all fairness, if one regards the OECD Model as the standard to be imitated, this writer believes that the U.S.-French treaty approaches the standard more than any other treaty the U.S. has concluded, in the context of the taxation of American citizens residing overseas.

The specific method of avoiding double taxation of U.S. dividends, interest, royalties and capital gains is unique to U.S. tax treaties. But while simple in concept, the method is difficult to apply. The general rule is that the U.S. will obtain its share of the worldwide tax as defined in Articles 9, 10, 11, 12 (without application of the savings clause, Article 22(4)(a)), and France will get any additional tax. Unfortunately, the Treaty does not express itself in such terms. It uses the complicated jargon of the foreign tax credit to do this.⁷¹ The advantage to the U.S. of the Treaty's system is that the savings clause does remain operative, providing a possible second opportunity for the U.S. to tax the U.S. income.

This can be illustrated where the amount of taxable passive investment income is such that it falls within the highest tax brackets in the U.S. and France, respectively 70% and 60%. On U.S. interest in the amount of \$1000 paid to a resident of France, the U.S. has a first right to 10%, or \$100. France has the right to \$600 less \$100 tax credit, or \$500. The U.S., having the higher tax rate then can claim an additional \$100, the difference between 70% and 60% of \$1000. Thus the world-

⁶⁸ See notes 109-111 and accompanying text *infra*.

⁶⁹ French Treaty, *supra* note 10, at arts. 23(2)(b), 23(3)(b).

⁷⁰ *Id.* at art. 23(2)(c). Although a similar provision existed in the Treaty before the new Protocol, it was rarely, if ever applied because relief was sought under internal French law Article 164-1, note 5 *supra*, not the Treaty.

⁷¹ French Treaty, *supra* note 10, at arts. 23(1), 23(3).

wide tax is at the higher of the two countries' rates and equals \$700, with \$200 going to the U.S. and \$500 going to France. It should be noted, however, that even in this type of case, the extra \$100 due to the U.S. will be considered as tax on foreign source income.

The U.S. will have the right to 10% of U.S. source interest, 15% of U.S. source dividends, no percentage of U.S. capital gains (except on real estate as discussed below), and zero or 5% of U.S. royalties.⁷² The sacred savings clause of the Convention in effect necessitates a formula for backing into this result: its method is to change the definition of the source income. Article 23(3)(b) states:

The United States, in determining the amount of credit allowable for foreign taxes, shall consider as income from sources within the United States only that portion of each item of income referred to in subparagraph (b) of paragraph (2) [dividends, interest, royalties and capital gains] which is equal to the ratio of $\frac{X}{Y}$ where:

- (i) X is the rate of tax which the United States would be entitled to levy if the individual deriving the income were not a citizen of the United States, and
- (ii) Y is the effective rate of tax (before reduction by investment tax credit or foreign tax credit) which the United States levies for the year on the individual's gross income.

*The proportion of each item of income which is not considered as from sources within the United States under this subparagraph shall be considered as from sources within France. The provision of this subparagraph shall apply only to the extent that an item of income is included in gross income for purposes of determining French tax.*⁷³

The effect of this formula can best be illustrated by using a simple example:

EXAMPLE

Retired U.S. citizen resident in France (married, no children)

	Dollars
U.S. Private Pension (for services performed in the U.S.)	10,000
U.S. Dividend Income	<u>20,000</u>
Gross Income	30,000
U.S. tax before credit	5,593
French tax before credit (pension is exempt from French tax but used for rate calculation)	5,317

⁷² See notes 76-98 and accompanying text *infra*.

⁷³ French Treaty, *supra* note 10, at art. 23(3)(b). Items of income listed within brackets refer to Articles 9, 10, 11 and 12 as listed in Article 23 (emphasis added).

CREDITS

FRENCH credit for U.S. tax
15 % of dividends (3,000)

U.S. credit for French tax
dividends $\times \frac{15\%}{\text{effective U.S. tax rate}} = \text{U.S. Source}$

$$20,000 \times \frac{.15}{\frac{5.593}{30,000}} = 16,092$$

$$20,000 - 16,092 = 3,908 \text{ foreign source}$$

$$3,908 \times 5,593 = 729$$

$$30,000$$

$$\text{Lesser of } 729 \text{ or } 5,317 - 3,000 = 2,317 \quad (729)$$

Total tax worldwide	<u>7,181</u>
Total U.S. tax after credits 5,593 - 729	4,864
Total French tax: 5,317 - 3,000	<u>2,317</u>
Total worldwide tax	<u>7,181</u>

The U.S. tax on dividends is \$3,000, or 15 % of the dividends. The U.S. tax on pension is $10,000 \times .1864$ (effective U.S. tax rate) = \$1,864. Total U.S. tax: \$3,000 + \$1,864 = \$4,864.

The French tax is purely on dividends: \$5,317 less the U.S. tax on dividends of \$3,000 = \$2,317.

The worldwide tax is the higher of the two countries' taxes before credits on dividends, or the French tax of \$5,317 plus the higher of the two countries' taxes on the pension, or the U.S. tax of \$1,864: \$5,317 + \$1,864 = \$7,181.

In preparing U.S. tax returns for Americans residing in France, this formula should be applied whenever the relevant income has been taxed by France. There are a myriad of questions evoked in practical applications; little guidance can be found in the Internal Revenue Code or in other published U.S. reports. Most of the questions are definitional in nature. However, a key phrase in Article 23(3)(a), and repeated in paragraph (b)(i) of the same article (both deal with U.S. tax relief), is the amount or rate, respectively, of "tax which the United States would be entitled to levy in respect of the item of income *if the individual deriving the income were not a citizen of the United States.*"⁷⁴

⁷⁴ *Id.* at art. 23(3)(a) (emphasis added).

Additionally, the French tax relief provided in Article 23(2)(b) states that:

As regards income taxable in the United States under Articles 9, 10, 11, or 12 and income to which paragraph (4)(b) of Article 22 applies, France shall allow to a resident of France a tax credit corresponding to the amount of tax levied by the *United States under this Convention other than by reason of citizenship*. Such tax credit, not to exceed the amount of French tax levied on such income, shall be allowed against taxes mentioned in subparagraph (1)(b)(i) of Article 1 of the Convention in the bases of which such income is included.⁷⁵

Thus, when studying the U.S.-French treaty for avoidance of double taxation on passive investment income, it would appear that one must ignore momentarily that the French resident, taxable on worldwide income, is also a U.S. citizen. In actuality, however, that is easier said than done, as seen below by a description of specific areas covered or not covered by the Treaty. These questions are raised in order to encourage attempts to resolve them.

Interest. All interest income from the U.S. is taxable in France.⁷⁶ The kinds of U.S. interest, however, which clearly qualify for the 10% credit against French tax is uncertain. For example, interest on municipal bonds are taxable in France; under U.S. law, such interest is tax-exempt and would not be subject to a 10% income tax for either a French or U.S. citizen. Thus, although the wording of the Treaty can be read to permit a 10% credit to be applied against municipal bond interest, the French authorities have interpreted the revised Treaty to deny the credit.⁷⁷

Interest earned on U.S. savings accounts presents a slightly different case in that such interest is taxable to the U.S. citizens or residents but *not to French citizens* residing in France under *internal* U.S. tax law.⁷⁸ Here again, the wording of the Treaty permits the 10% credit to be applied, and given the lack of French or U.S. official clarification, a reasonable interpretation is that the credit will be allowed because the U.S. citizen would normally be taxed in the U.S. on this interest in-

⁷⁵ *Id.* at art. 23(2)(b) (emphasis added).

⁷⁶ *Id.* at art. 10(1).

⁷⁷ Instruction, *supra* note 32, at para. II(5).

⁷⁸ This distinction results from the interaction of I.R.C. sections 872 and 861(c). Section 872 includes for nonresident alien individuals gross income from sources within the United States, while section 861(c) states that interest from deposits in U.S. banks are not considered to be U.S. source income. It should be noted, however, that this applies to nonresident alien individuals only.

come.⁷⁹

Dividends. U.S. source dividends are fully taxable in France, subject to a 15% credit.⁸⁰ It is not obvious, however, how certain types of U.S. dividends will be treated by the French tax authorities. These include U.S. corporate capital gains distributions (where capital gains are distributed to shareholders), "dividends" from essentially interest-yielding liquid asset funds, and U.S. corporate "return of capital" distributions (reduction in basis in the U.S. since they are not distributed out of earnings and profits).

Royalties. All U.S. royalties must be fully reported on French residents' French tax returns, whether they benefit from favorable treaty provisions or not.⁸¹ Royalties from U.S. mineral rights are exempt, however, from French tax in France under the Treaty,⁸² which conforms to the OECD Model that real property income is taxed at the situs of the realty.⁸³ Royalties from U.S. know-how or patents are entitled to a tax credit of 5% against the French tax,⁸⁴ but royalties from literary, artistic or scientific works are fully taxable in France to the U.S. resident recipient.⁸⁵

Capital gains. Capital gains on securities sold on a stock exchange in any country by French residents are subject to tax in France without credit for any U.S. tax paid.⁸⁶ It happens that 1979 was also the first year for application of the new domestic French capital gains law.⁸⁷ Prior to 1979, capital gains on securities transactions were generally not taxed to individuals.⁸⁸

Under the new law, when securities sales exceed 100,000 French francs during a year, such gains *may* be taxable in France. In addition, all "speculative" transactions are considered taxable regardless of amount. Capital losses are allowed only against capital gains and may

⁷⁹ The French Tax Declaration, form No. 2047, used for reporting such income and calculating the credit does not provide, however, a space for a foreign tax credit on savings account interest.

⁸⁰ French Treaty, *supra* note 10, at art. 9.

⁸¹ Instruction, *supra* note 32, at para. II(5).

⁸² French Treaty, *supra* note 10, at art. 5.

⁸³ OECD Model, *supra* note 3, at art. 6.

⁸⁴ French Treaty, *supra* note 10, at art. 11.

⁸⁵ *Id.* at art. 11(3).

⁸⁶ *Id.* at art. 12.

⁸⁷ See note 89 and accompanying text *infra*.

⁸⁸ [1979] CODE GÉNÉRAL DES IMPÔTS, art. 160.

be carried forward.⁸⁹

One of the complications of the French law is a transitional measure providing for a stepped-up cost basis which may be elected for shares held in 1978 to the highest value of 1978.⁹⁰ This can result in the computation of a low gain or even a loss for French tax purposes compared to a sizeable gain in the U.S. Although this is obviously advantageous to the taxpayer in France, it is unclear as to how the difference in taxable amount will be treated for U.S. purposes. The wording of the Protocol merely allows that an otherwise U.S. source capital gain which is taxed in France will become foreign source, allowing a credit for French taxes. The U.S. authorities must also tackle the question of how to treat U.S. capital losses that are not "taxed" in France but are reported there.⁹¹

U.S. Real Property Income. The discussion in the French Instruction of February 19, 1980, on capital gains on the sale of U.S. real estate may be termed "opportunistic."⁹² Article 5 of the Treaty, unchanged by the Protocol, clearly permits the U.S. to tax income from U.S. real estate, including capital gains, while France has seemingly given up the power to do so. Under the Treaty, before amendment by the new Protocol, France interpreted Article 5 to mean that it would not tax such gains.⁹³ Unpublished assurances of continued non-taxation were made before publication of the February ruling.⁹⁴

Now, however, the Instruction relies on new Article 23, in which no distinction is made between capital gains on securities and on real property, to conclude that France has the right to tax capital gains on U.S. real property, subject to a credit for the U.S. tax on the gain. The exact method of determining the amount of U.S. credit is not provided. Under U.S. law, at the time of this writing, generally a zero tax would apply to a French citizen having a capital gain on U.S. realty.⁹⁵ This position represents a departure from the French tax treaty tradition of

⁸⁹ *Id.* art. 92 (in which "speculative" transactions are specifically defined).

⁹⁰ *Id.*

⁹¹ See DEPT OF THE TREASURY, INTERNAL REVENUE SERVICE, PUB. NO. 514, *Foreign Tax Credit for U.S. Citizens and Resident Aliens* (Rev. Nov. 79), in which the I.R.S. states that for such "U.S. capital gains, the entire gain is treated as French source. For example, you had a gain from the sale of U.S. securities in a year when you were not in the United States more than 183 days." *Id.* at 5.

⁹² Instruction, *supra* note 32, at para. I(7).

⁹³ *Id.*

⁹⁴ Telephone conversation between Direction Général des Impôts and the author (Nov. 6, 1979).

⁹⁵ I.R.C. § 871(a)(2).

relinquishing taxation of foreign real property income and is probably contrary to the understanding of the U.S. negotiating team.⁹⁶ Yet, under the Treaty, rental income from real property in the U.S., whether held outright or in a partnership, is not taxable in France.⁹⁷

Trust and Estate Income. Neither trust nor estate income is referred to specifically in the revised Treaty or official U.S. or French publications. Their absence, however, would imply that the income from a trust or an estate must be regarded on a transparent basis, as to nature and source. This view conforms to U.S. law, but is contrary to the French viewpoint. Specifically, the French law provides that "trust" income will be taxed as income from movable property.⁹⁸ If this rule were applied in the context of the Treaty, which treaty tax credit rate would apply? This important question was in fact raised in the French Senate ratification debate. The authorities claimed they would view trusts as transparent, implying they would look to the actual trust assets to determine type and source of income.⁹⁹ The authorities might also be implying that the terms of the trust regarding beneficiaries, accumulations, etc., might be disregarded for French tax purposes as they often are for U.S. tax purposes.¹⁰⁰ Unofficial opinions from the authorities confirm this view.¹⁰¹ Nevertheless, there are many types of trusts in the U.S., taxable in different ways. Trusts do not exist in France. The French are currently reviewing how, to whom and when trusts will be taxed in France.

U.S. Effective Tax Rate Used in Sourcing Ratio

A mathematical calculation is required, as seen above,¹⁰² in con-

⁹⁶ The argument against the French interpretation is that it is Article 5 which governs the taxation of the U.S. real property income and Article 23(2)(a)(1) which exempts such income from tax in France. Article 12(2)(a) excludes real property capital gains from the scope of Article 12 and, thus, from the scope of Article 23(2)(b). Additionally, the French interpretation makes application of Article 23(3)(b) absurd: a U.S. capital gain on real property would be converted to French source in direct contradiction to the spirit of Article 5 and to the French Instruction itself. Finally, Article 23(3)(a), which covers the case of the U.S. citizen resident in France provides that the tax credit to be granted by France shall be zero, not the U.S. tax, with respect to capital gains.

⁹⁷ French Treaty, *supra* note 10, at art. 5.

⁹⁸ [1979] CODE GÉNÉRAL DES IMPÔTS, art. 120-9.

⁹⁹ The French Tax Authorities went on record in the French Senate debate on ratification of the Protocol as expecting transparent tax treatment on trusts. See [1979] JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] 2396-2400.

¹⁰⁰ *Id.* Debates on the adoption of the Protocol in the French Senate (June 27, 1979).

¹⁰¹ This tendency has been unofficially confirmed at various meetings between tax consultants and the French Tax Authorities.

¹⁰² See text accompanying note 73 *supra*.

verting U.S. income to French source. The ratio printed above uses the term "gross income" in defining the denominator:

Y is the effective rate of tax (before reduction by investment tax credit or foreign tax credit) which the United States levies for the year on the individual's *gross income*.¹⁰³

"Gross income" is a defined term under U.S. tax law.¹⁰⁴ If the U.S. internal tax definition of gross income is used, however, the desired results of the ratio will frequently not be obtained, resulting in *de facto* double taxation: the U.S. tax of 10% on interest, 15% on dividends, none on capital gains, and zero or 5% on royalties, may in fact be increased.

In reflecting on this, one must realize that "gross income," under section 61:

- includes gross business income before off-setting of relevant expenses,
- includes gross capital gains, before reduction by capital losses or the long-term capital gains deduction of 60%,
- includes gross rental receipts before reduction for depreciation and expenses,
- includes employer-paid reimbursements for moving expenses before a deduction for conceivably the same amount,
- includes salaries, before reduction by the foreign earned income deductions or employee business expenses.¹⁰⁵

To fulfill the aim of the Protocol, "taxable income" or at least "adjusted gross income" would be a better measure of the effective tax rate than gross income. "Adjusted gross income" reduces gross income by business-related expenses and other adjustments to income mentioned above, while "taxable income" further reduces it by itemized deductions allowable.¹⁰⁶

The difficulty in using "gross income" can be easily illustrated by using the example presented earlier,¹⁰⁷ but assuming that there was rental income (either U.S. or foreign) of \$10,000 and rental expense and depreciation of \$10,000. The net rental income being zero, there is no difference in U.S. tax before credits. Since an additional \$10,000 is added to gross income, however, the effective tax rate becomes 14%, and no income at all is converted to foreign source. No U.S. foreign

¹⁰³ French Treaty, *supra* note 10, at art. 23(3)(b)(ii) (emphasis added).

¹⁰⁴ I.R.C. § 61.

¹⁰⁵ *Id.*

¹⁰⁶ I.R.C. §§ 62, 63.

¹⁰⁷ See pp. 468-69 *supra*.

tax credit being permitted, the worldwide tax is increased by \$729 to \$7910, because no consideration was given to the rental expenses in the effective tax rate calculation. The use of "adjusted gross income" rather than gross income would, in this example, revive the \$729 foreign tax credit. The one I.R.S. example published to date, simplistic in the extreme, avoids this definitional issue by not identifying \$23,700 out of \$25,000 of "gross income."¹⁰⁸

French Higher Tax Rate. The U.S. citizen residing in France must report his worldwide income in the French return, specifying any amounts exempt from French tax under the Treaty.¹⁰⁹ The French authorities may calculate the French tax at the higher average tax rate which would have applied had the income not been exempt.¹¹⁰ The Exchange of Letters released with the Protocol, and the February 19, 1980 French Instruction both specify that the income taxable in France under the Treaty is multiplied by a rate obtained by dividing the tax on income as if no income were exempt, by that same amount of worldwide income.¹¹¹ Any foreign tax credits will then reduce the tax so obtained.

CONCLUSION

American citizens residing in France have found themselves, in many cases, with not only higher overall tax burdens, but also confronting a substantial task in applying the provisions for relief from double taxation. Their various reactions have been to relocate, to seek costly professional assistance, or to regard the new compliance and tax burden as simply another cost of residing in France.

The revised Treaty, however, provides the theoretical means for an equitable division of tax revenues with a result approaching the OECD Model as regards U.S. citizens residing abroad. The Report of the Department of State modestly affirms that the "Protocol is the first agreement in which the residence and citizenship bases of taxation have been divided up in a comprehensive manner."¹¹² More importantly, the right of the residence country truly to tax U.S. income has been recognized. Unfortunately, achievement of this principle has resulted in an increased tax burden for many Americans residing in France.

¹⁰⁸ *Foreign Tax Credit for U.S. Citizens and Resident Aliens*, *supra* note 91, at 5.

¹⁰⁹ French Treaty, *supra* note 10, at art. 23(2)(c); Instruction, *supra* note 32, at para. III.

¹¹⁰ French Treaty, *supra* note 10, at art. 23(2)(c).

¹¹¹ Letters Attached to the Protocol of Nov. 24, 1978, *supra* note 35, at para. 3(f); Instruction, *supra* note 32, at para. III.

¹¹² Report of the Dept. of State, [1980] 1 TAX TREATIES (CCH) ¶2836B, 2819-7E.