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

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On November 10, 2009

Prepared by the Staff
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"Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and France"

VI. ISSUES

A. Arbitration

At page 66, the two paragraphs under the subheading **"Absence of reasoned opinion and precedential value"** are replaced with the following text:

Like the treaties with Belgium and Germany, the proposed protocol provides that the arbitration board will limit its determination to stating an amount of income, expense, or tax reportable to the treaty countries. The determination will not state a rationale and will have no precedential value. Arbitration board determinations under the treaties with Belgium and Germany also will not include rationales and will have no precedential value.

The requirement that the arbitration board not provide a rationale appears to follow from the "last best offer" structure of the arbitration process.[1] The arbitration board must choose one of the two proposals submitted to it by the competent authorities without modification. As a result, the arbitration board's decision does not necessarily represent the independent view of the board as to the "right" answer, but rather its decision as to which of the two offers is the least wrong. It has been suggested that a reasoned decision in these circumstances would be less helpful than it might be in a case in which the arbitration board is permitted or required to reach its own conclusion as to how to resolve a matter. The Committee may wish to inquire, however, into the possible significance of the proposed protocol's omission of any statement that arbitration board decisions should be taken into account in certain similar subsequent cases. Does the omission of such a statement mean that under the proposed protocol an arbitration board decision will have no consequence at all for future determinations?

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[1] The advantages and disadvantages of the "last best offer" approach are discussed generally in Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Belgium* (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007.

CONTENTS

INTRODUCTION

This pamphlet,[2] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States and France (the "proposed protocol").[3] The proposed protocol was signed on January 13, 2009. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for November 10, 2009.[4]

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of French tax laws. Part IV provides a discussion of investment and trade flows between the United States and France. Part V contains an article-by-article explanation of the proposed protocol. Part VI contains a discussion of issues relating to the proposed protocol.

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[2] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and France* (JCX-49-09), November 6, 2009. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at http://www.jct.gov/.

[3] The proposed protocol is accompanied by a Memorandum of Understanding.

[4] For a copy of the proposed protocol, see Senate Treaty Doc. 111-4.

I. SUMMARY

The principal purposes of the present treaty between the United States and France are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The present treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

The proposed protocol modifies several provisions in the Convention Between the United States and France with Respect to Taxes on Income and on Capital (signed on August 31, 1994, and amended by the protocol signed on December 8, 2004) (the "present treaty"). The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the United States Model Income Tax Convention of November 15, 2006 ("U.S. Model treaty"), and the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development ("OECD Model treaty"). However, the present treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed protocol in Part V of this pamphlet.

The proposed protocol makes changes to Article 4 (Resident) of the present treaty that in general make the rules conform more closely to the rules of other recent U.S. income tax treaties and protocols. Among other changes, the proposed protocol provides a special rule for French qualified partnerships and includes rules for fiscally transparent entities, which are entities that are not subject to tax at the entity level, that are similar to rules found in other recent U.S. income tax treaties. One difference from recent U.S. treaties is the addition of a requirement that, when a fiscally transparent entity formed or organized outside the United States or France derives an item of income, profit, or gain from U.S. or French sources, the fiscally transparent entities rules apply only if the country in which the entity is organized has concluded with the treaty country from which the income, profit, or gain is derived an agreement including an exchange of information provision intended to prevent tax evasion.

The proposed protocol replaces Article 10 (Dividends) of the present treaty. The new article generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable 15-percent maximum withholding rate and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Like several other recent treaties and protocols, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. As in the present treaty, special rules apply to dividends received from a regulated investment company, a real estate investment trust, and a société d'investissement à capital variable; under the proposed protocol, these rules are extended to a "société d'investissement immobilier cotée" and a "société de placement à prépondérance immobilière à capital variable."

Article 12 (Royalties) of the present treaty is revised to provide that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty

country are exempt from taxation in the source country. Under the present treaty, the source country may impose up to a five-percent withholding tax on gross royalty payments.

The proposed protocol makes conforming changes to Article 13 (Capital Gains) to reflect revisions made to Article 12 (Royalties). It also updates Article 17 (Artistes and Sportsmen) to reflect the fact that the French currency is now the euro.

The proposed protocol clarifies that the exclusive source-country tax rule of Article 18 (Pensions) for payments arising under the social security legislation or similar legislation of one of the treaty countries to a resident of the other treaty country applies, in the case of payments arising under France's social security legislation, to payments made not only to residents of the United States, but also to citizens of the United States who are residents of France. Accordingly, notwithstanding the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions), the United States may not tax French social security payments made to a U.S. citizen resident in France.

Article 22 (Other Income) of the present treaty is replaced with a new article that conforms to the corresponding U.S. Model treaty provision. The article generally assigns taxing jurisdiction over income not dealt with in the other articles of the treaty to the residence country of the beneficial owner of the income.

The proposed protocol switches the order of two paragraphs of Article 24 (Relief from Double Taxation), clarifies that companies that are French residents may elect to be taxed on a worldwide basis subject to a credit in lieu of applying the general exemption system in France to foreign business income, and makes several conforming changes.

The proposed protocol changes cross-references that Article 25 (Non-Discrimination) makes to provisions of Articles 10 (Dividends) and 12 (Royalties). These changes in cross-references reflect the proposed protocol's renumbering of certain paragraphs of Articles 10 and 12.

The proposed protocol changes the voluntary arbitration procedure of Article 26 (Mutual Agreement Procedure) of the treaty to a mandatory arbitration procedure that is sometimes referred to as "last best offer" arbitration, in which each of the competent authorities proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. Under the proposed protocol, unless a taxpayer or other "concerned person" (in general, a person whose tax liability is affected by the arbitration determination) does not accept the arbitration determination, it is binding on the treaty countries with respect to the case. A mandatory and binding arbitration procedure is included in the U.S. income tax treaties with Belgium, Canada, and Germany.

Mutual administrative assistance is modernized under the proposed protocol. The proposed protocol replaces Article 27 (Exchange of Information) of the present treaty with rules that conform closely to the U.S. Model treaty. The proposed rules generally provide that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the domestic laws of the United States and France concerning taxes imposed at a national level, to the extent the taxation under those laws is not contrary to the treaty.

Article 28 (Assistance in Collection) of the present treaty is modified to remove an obsolete reference to former paragraph 4 of Article 10 (Dividends).

The proposed protocol amends Article 29 (Miscellaneous Provisions) of the present treaty, updating the saving clause to provide that France may tax entities that have their place of effective management in France, and which are subject to tax in France, notwithstanding the new fiscally transparent entity provision in Article 4 (Resident). It also updates the definition of former citizen and long-term residents to conform with the changes to section 877 of the Code and makes conforming changes to other paragraphs in Article 29. The proposed protocol adds a new rule to Article 29 that payments made by French government agencies to lawful permanent residents of the United States will be taxable only in the United States.

Article 30 (Limitation on Benefits) of the present treaty is replaced with a new article that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits solely by reason of residence in France or the United States.

The proposed protocol modifies Article 32 (Provisions for Implementation) of the present treaty to delete obsolete references to former paragraph 4(i) of Article 10 (Dividends) and former paragraph 8 of Article 30 (Limitation on Benefits).

Finally, Article XVI of the proposed protocol provides for the entry into force of the proposed protocol. The treaty countries will notify each other in writing when their respective constitutional and statutory requirements for entry into force of the protocol have been satisfied. The proposed protocol will enter into force on the date of receipt of the latter of such notifications. For withholding taxes, the proposed protocol has effect with respect to amounts paid or credited on or after January 1st of the calendar year in which the proposed protocol enters into force. For all other taxes, the proposed protocol has effect for taxes imposed for tax periods beginning on or after January 1st of the year immediately after the date on which the proposed protocol enters into force. With respect to the binding arbitration rules of Article 26 (Mutual Agreement Procedures), the proposed protocol is effective for cases under consideration by the competent authorities as of the date the proposed protocol enters into force and cases that come under consideration thereafter.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

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

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, special limitations apply to credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil related income.

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

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner. In particular, under the U.S. Model treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and, although not provided for in the U.S. Model treaty, many recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when the information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. Several recent treaties and protocols provide that notwithstanding the general treaty principle that treaty countries are not required to take any actions at variance with their domestic laws, a treaty country may not refuse to provide information requested by the other treaty country simply because the requested information is maintained by a financial institution, nominee, or person acting in an agency or fiduciary capacity. This provision thus explicitly overrides bank secrecy rules of the requested treaty country. The Internal Revenue Service (the "IRS"), and the treaty partner's tax authorities, also can request specific tax information from a treaty partner. These requests can include information to be used in criminal investigations or prosecutions.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments. Several recent treaties also provide for mandatory arbitration of disputes that the competent authorities are unable to resolve by mutual agreement.

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

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

III. OVERVIEW OF TAXATION IN FRANCE[5]

A. National Income Taxes

Overview

France imposes tax on net income at the national level. The definition of income subject to tax is expansive and includes capital gains.[6] Taxable income is computed on an annual basis and is taxed by assessment or by withholding tax.[7] Withholding tax paid may be credited against the income tax liability, and any excess may be refunded.[8] Aside from few special exceptions, French residents and nonresidents are generally subject to the same rules and tax rates on French-source income.[9]

Individuals

Individuals resident in France are subject to tax on their worldwide income.[10] An individual's taxable income is the sum of the net income from the following sources: employment income, business income, income from immovable property, investment income (income from movable property), and capital gains.[11] Generally, losses of one category of income may be set off against income of another category however capital losses from the disposal of immovable property may not be set off against any income category. Generally, losses can be carried forward for six years.[12] French-source dividends and interest income may be subject, at the taxpayer election to a final withholding tax of 18 percent (plus social contributions, making an effective overall rate of 30.1 percent).[13] Capital gains from the disposal

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[5] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part IBFD Regional Analysis, France, available at http://checkpoint.riag.com [hereinafter IBFD France Country Survey or IBFD France Country Analysis, as the case may be], Ernst & Young's 2009 Worldwide Corporate Tax Guide [hereinafter E&Y], as well as the Code Général des Impôts (Dalloz 2009) [General Tax Code, hereinafter C.G.I.]. The information in this section was reviewed by foreign law specialists on the staff of the Law Library of Congress. The description is intended to serve as a general overview; many details have been omitted and simplifying generalizations made.

[6] C.G.I. art. 1 A; IBFD France Country Survey A.1.3.1.

[7] C.G.I. arts. 12, 13, 156; IBFD France Country Survey B.1.10.

[8] IBFD France Country Analysis B.1.5.3.

[9] IBFD France Country Survey B.6.3.

[10] C.G.I. art. 4 A; IBFD France Country Survey B.6.1.1.

[11] C.G.I. art. 1 A; IBFD France Country Survey B.1.2.1.

[12] C.G.I. art. 156(I); IBFD France Country Survey B.1.8.

[13] C.G.I. art. 117 quarter; IBFD France Country Analysis B.1.10.3.

of business assets by an individual may be taxed in one of two ways, depending on whether they are short-term or long-term gains. Short-term gains (i.e., gains from the disposal of assets held for less than two years) are taxed as business income. Long-term gains (i.e., gains from the disposal of assets held for at least two years) are subject to tax at a flat rate of 16 percent, increased to 28.1 percent by the 12.1 percent social taxes.[14] Certain deductions, including expenses related to the family situation of the taxpayer, are allowed against the total taxable income. Also, income tax computed on the aggregate income is reduced by tax credits including interest on mortgage loans, child's education expenses, gifts and charitable contributions, and care of elderly dependent persons.[15] The rate structure is progressive and for tax year 2008 extends from zero percent for taxable income up to €5,852 ($8,218)[16] to 40 percent for taxable income exceeding €69,505 ($97,606).[17]

Corporations

Companies resident in France are generally subject to tax on a territorial basis. Accordingly, except for passive income, business income realized through enterprises operating outside France is not taken into account for French tax purposes nor are losses pertaining to such enterprises.[18] A corporation is resident in France if it has legal seat or place of effective management in France.[19]

In general, all income derived by a corporation is taxable business income.[20] Unless the participation exemption applies, dividends derived by corporate shareholders are included in the taxable income subject to the general tax rate. The participation exemption is available electively for resident parent companies in respect of dividends received from their resident and nonresident subsidiaries. To qualify for the regime, the parent must have a participation in the subsidiary equal to at least five percent of the subsidiary's capital and must have held the participation for at least two years (or commit to hold the shares for at least two years).[21] Capital gains are normally taxed at ordinary rates, but capital gains on shares in listed real estate companies (the value of the assets of which consists of more than 50 percent of immovable

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[14] C.G.I. art. 39 quindecies; IBFD France Country Survey B.1.6.

[15] C.G.I. art. 156(II); IBFD France Country Survey B.1.7.

[16] The quoted tax rates and local currency apply in 2009. U.S. dollar equivalents were calculated using the exchange rate for January 1, 2009 according to OANDA's FX Converter, available at www.oanda.com.

[17] IBFD France Country Survey B.1.9.1.3.

[18] C.G.I. art. 209(I); IBFD France Country Survey A.1.3.1.

[19] IBFD France Country Analysis A.1.1.5.

[20] C.G.I. art. 38; IBFD France Country Survey A.1.3.1.

[21] C.G.I. art. 145; IBFD France Country Survey A.2.2.

property) are subject to a reduced tax rate of 19 percent.[22] The standard corporate tax rate is 33⅓ percent[23]; however, small and medium-sized enterprises are taxed at a reduced rate of 15 percent on the first €38,120 ($53,532) of profits and at the standard rate on any excess.[24] In addition, large companies (i.e., companies whose revenue exceeds €7,630,000 ($10,714,809)) are subject to an additional social surcharge of 3.3 percent levied on that part of aggregate corporate tax, calculated at the above standard rate, that exceeds €763,000 ($1,071,481). Thus, the resulting effective rate on that part is 34.43 percent.[25] There are no withholding taxes on dividends, interest, and royalties paid to resident companies.[26]

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[22] C.G.I. art. 210 E; IBFD France Country Survey A.1.4.1.

[23] C.G.I. art. 219 (I).

[24] *Ibid*. art. 219 (I)(b).

[25] *Ibid*. arts. 235 ter ZC, 213.

[26] IBFD France Country Survey A.1.6.

B. International Aspects of Taxation in France

Individuals

Individuals resident in France are subject to tax on their worldwide income.[27] French resident individuals are individuals who have a home or principal abode in France, perform employment or independent services (unless such activity is only ancillary) or have their center of economic interests in France.[28] Nonresident individuals are generally subject to the same tax rules and tax rates on their French-source income as those generally applicable to resident individuals.[29] The deductions and credits which apply to residents' aggregate income are not available for nonresidents.[30] French-source income includes: income from real property located in France; income from French securities and other capital invested in France; income from a business operating in France; income derived from professional activities carried out in France; capital gains on the sale of real property or real property rights and on the sale of shares in companies registered in France, where such gains are taxable under French law; sums paid in remuneration of performances given in France by artists and athletes; and pension and life annuities, proceeds and royalties of industrial and intellectual property rights, and amounts paid in remuneration of services of all kinds supplied or used in France, whenever the debtor paying such income resides in France.[31] France imposes a 25-percent (reduced to 18 percent or 15 percent in certain cases) withholding tax on dividends paid by resident companies to nonresident individuals.[32] Interest income arising from French sources is subject to 18-percent (reduced to 15, 12, or zero percent in some cases and in other cases may be increased to 35 percent) withholding tax.[33] Royalties paid to nonresidents who are not established in France are subject to a withholding tax of 33⅓ percent. A French-source capital gain on the sale of property is subject to 33⅓ percent (reduced to 16 percent or increased to 50 percent in certain cases).[34] Capital gains on sales of substantial shareholdings (where the shareholder directly or indirectly (i.e., through relatives) holds or has held at any time during the preceding five-year period 25 percent or more of the shares) is subject to 16-percent withholding tax.[35] The French tax code provides for a "twice in a lifetime" capital gains tax exemption in favor of European Union ("EU")

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[27] C.G.I. art. 4 A; IBFD France Country Survey B.6.1.1.

[28] C.G.I. art. 4 B; IBFD France Country Survey B.1.1.

[29] C.G.I. art. 4 A-2.

[30] IBFD France Country Survey B.6.3.1.1.

[31] C.G.I. art. 164 B; IBFD France Country Analysis B.7.3.1.

[32] C.G.I. arts. 119bis 1, 187-1.

[33] *Ibid*. art. 125 A.

[34] *Ibid.* arts. 244bis, 244bis A.

[35] *Ibid.* arts. 150-0 A, 244bis B; IBFD France Country Analysis B.7.3.2.

nationals or nationals of another member state of the European Economic Area ("EEA") with which France has signed a treaty containing an administrative assistance clause.[36]

Corporations

Companies resident in France are subject to tax on a territorial basis. Tax is due only on business income generated by enterprises (a permanent establishment, a dependent representative or a "full commercial cycle") operating in France. Therefore, subject to various treaty provisions, business income derived from foreign operations is not subject to French tax. Accordingly, business income realized through enterprises operating outside France is not taken into account for French tax purposes nor are losses pertaining to such enterprises. Nevertheless, tax is imposed on worldwide income that is from passive foreign sources (for example, royalties, dividends, and interest), unless it can be shown that such income is connected to the operations of a foreign branch.[37]

A corporation is resident in France if it has a legal seat or place of effective management in France.[38] A foreign company carrying on business activities in France is subject to the same tax rules and tax rates as resident companies on: all French-source income connected with the activities; capital gains from immovable property in France; and capital gains from the disposition of participation shares (at least 25 percent of the shares must be held in order to qualify as participation shares) in French companies. However, only the capital gains from assets which are effectively connected with the French activity are taxable. Passive investment income of a foreign company not effectively connected to business activities in France normally only bears withholding taxes.[39]

Dividends distributed to nonresident shareholders are subject to a final withholding tax at a rate of 25 percent.[40] In the case of dividends paid to another EEA country, except Liechtenstein, the rate is reduced to 18 percent.[41] However, there is no withholding tax on dividends paid by a resident company to a qualifying EU parent company, if, among other conditions, the recipient holds ten percent, or more of the shares of the subsidiary for at least two years.[42] Significant categories of French-source interest payments are exempt from withholding tax, including interest on loans contracted by French companies abroad, bank deposits, state bonds, corporate bonds, and certain negotiable debt instruments that are traded on a regulated

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[36] C.G.I. art. 150 U; IBFD France Country Analysis B.7.3.1.6.

[37] C.G.I. art. 209(I)(1); IBFD France Country Survey A.1.3.1.

[38] IBFD France Country Analysis A.1.1.5.

[39] IBFD France Country Analysis A.7.3.5.

[40] C.G.I. art. 150-O A.

[41] IBFD France Country Survey A.6.3.1.

[42] C.G.I. art. 119 ter; E&Y, p. 296.

market but cannot be quoted on the stock exchange. In other cases, gross interest paid to nonresidents is subject to a final withholding tax at a rate of 18 percent.[43] Gross royalties are subject to withholding tax at a rate of 33⅓ percent.[44] Interest and royalty payments between two "associated companies" of different EU states are exempt from withholding tax.[45] Two companies are "associated companies" if (a) one of them has a direct minimum holding of 25 percent in the capital of the other or (b) a third EU company has a direct minimum holding of 25 percent in the capital of the two companies. A minimum holding period of two years is required.[46] Capital gains on immovable property situated in France realized by foreign companies that do not have a permanent establishment in France are subject to withholding tax at a rate of 33⅓ percent for occasional gains[47] and 50 percent for recurrent gains.[48] The tax is paid at the time of the registration of the transfer. The tax paid is credited against the corporate tax liability. If the withholding exceeds the liability, the excess tax payment will be refunded upon request.[49] Non-EU companies are subject to a branch profits tax at a rate of 25 percent on the after-tax profits of their permanent establishments in France.[50]

Relief from double taxation

In the case of foreign-source business income, the main unilateral relief from double taxation is the territorial system of taxation. Foreign-source passive investment income, such as dividends, interest and royalties, is included in the taxable base. There is generally no credit for foreign taxes under domestic law, but foreign taxes levied by nontreaty countries are deductible as expenses.[51]

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[43] IBFD France Country Survey A.6.3.2.

[44] C.G.I. art. 182 B; IBFD France Country Survey A.6.3.3.

[45] C.G.I. art. 119 quarter.

[46] *Ibid*.; E&Y, p. 296.

[47] C.G.I. art. 244bis A.

[48] *Ibid*. art. 244bis.

[49] *Ibid*. art. 244bis A.

[50] IBFD France Country Survey A.6.3.4.

[51] IBFD France Country Survey A.6.1.3.

C. Other Taxes

Inheritance, gift, and wealth taxes

France imposes an inheritance and gift tax on worldwide property transfers if the deceased person was, or the donor is a resident of France.[52] This tax is also imposed on worldwide property transfers if the beneficiary or donee is a resident of France.[53] In most cases, tax is imposed on the fair market value of the assets. Certain allowances and tax credits are available including a personal allowance of €156,357 ($219,572) applies to inheritances and gifts in direct lines and to mentally or physically handicapped beneficiaries.[54] An allowance of €15,636 ($21,957) is granted for inheritances and gifts between siblings.[55] The rates of the inheritance and gift tax are determined on the basis of the taxable amount and the proximity of relationship between the deceased/donor and the beneficiary or donee.[56]

Resident individuals are subject to an annual net wealth tax on the fair market value of assets owned on January 1st of the tax year, minus liabilities, if the net value of these assets exceeds €790,000 ($1,109,397).[57] A deduction of 30 percent of the value of the principal residence is granted.[58] In addition, various assets are fully or partially exempt from the tax, including business assets, antiques, works of art, collector's items, substantial holding of stock (more than 25 percent) held by managing directors, and certain life insurance policies.[59] The rate structure is progressive and extends to 1.8 percent for net assets value exceeding €16,480,000 ($23,142,864).[60]

Social security

Social security contributions are paid by employers, employees or both and are computed either on the total remuneration or on the maximum amounts. Paid contributions are deductible from the taxpayer's employment income.[61] The employee's share of the contributions is

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[52] C.G.I. art. 750 ter (1).

[53] *Ibid*. art. 750 ter (2).

[54] *Ibid*. art. 779.

[55] *Ibid*.

[56] IBFD France Country Survey B.5.4.

[57] C.G.I. art. 885 A.

[58] *Ibid*. art. 885 S.

[59] *Ibid*. art 885 H et seq.

[60] *Ibid*. art. 885 U; IBFD France Country Survey B.4.1.

[61] *Ibid*. art. 156(II); IBFD France Country Survey B.3.

generally approximately 18 percent to 24 percent of the employee's gross salary. The employer's total share of contributions is generally in the region of 45 percent of the employee's gross salary.[62] Self-employed individuals personally pay their own social security contributions to special funds. These contributions are based on their annual revenues as declared to the tax administration.[63]

Other indirect taxes

France imposes a value added tax ("VAT") on the consumption of goods and services. Although the VAT is levied at each stage of the economic chain, it is ultimately borne by the final customer. The VAT due on any sale is a percentage of the sale price less all the tax paid at the preceding stages. The standard VAT rate is 19.6 percent.[64] The rate is reduced for certain products and services and in some cases is zero.[65]

In general, there is no capital duty or similar duty on the formation and expansion of capital of companies. However, the contribution in exchange for shares of immovable property or rights in immovable property and going concerns or items deemed to be part of a going concern to entities subject to corporate income tax by individuals or entities that are not subject to corporate income tax are subject to a five-percent registration duty on the part of the value of the contributed asset which exceeds €23,000 ($32,299). Such contributions are exempt, however, if the contributor undertakes to hold the shares received for at least three years. In general, the sale of land and buildings is subject to registration duty at a rate of 5.09 percent on the transfer price, including expenses.[66]

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[62] IBFD France Country Analysis B.3.1.

[63] IBFD France Country Analysis B.3.2.

[64] C.G.I. art. 278.

[65] *Ibid*. arts. 278bis et seq.; IBFD France Country Survey A.8.

[66] IBFD France Country Survey A.9.

IV. THE UNITED STATES AND FRANCE: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for businesses in one country that aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that arises from different transactions, but may also increase or decrease that burden. If there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment have the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed protocol it may be beneficial to examine the cross-border trade and investment between the United States and France. Whether measured by trade in goods or services, or by direct and non-direct cross-border investment, the United States and France are important components of each country's current and financial accounts. Substantial cross-border investment by persons in both countries over the years has resulted in cross-border income flows generally in excess of $20 billion (real 2008 dollars) since 2000. The income from cross-border trade and investment generally is subject to income tax in either the United States or France and in many cases the income is subject both to gross basis withholding taxes in the source country.

B. Overview of International Transactions Between the United States and France

The value of trade between the United States and France is large. In 2008, the United States exported $28.8 billion of merchandise to France and imported $44.0 billion in merchandise from France.[67] These figures made France the United States' 11th largest merchandise export destination and the 10th largest source of imported merchandise. Similarly, the value of cross-border investment, U.S. investments in France and French investments in the United States, is large, but has declined since the most recent financial crisis began. In 2008, U.S. investments in France decreased by $57.0 billion and French investments in the United States decreased by $17.6 billion. Table 1, below, summarizes the international transactions between the United States and France in 2008.

Table 1 presents the balance of payments accounts between the United States and France. Two primary components comprise the balance of payments account: the current account and the financial account.[68] The current account measures flows of receipts from the current trade in goods and services between the United States and France and the flow of income receipts from investments by U.S. persons in France and by French persons in the United States. The financial account measures the change in U.S. investment in France and the change in French investment in the United States.

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[67] Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2008," June 10, 2009.

[68] The U.S. Department of Commerce, Bureau of Economic Analysis reports and describes international transactions by reference to a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled, as in Table 1: current account; financial account; and capital account. The current account measures flows of receipts from the current trade in goods and services between the United States and abroad and the flow of income receipts from investments by U.S. persons abroad and by foreign persons in the United States. Income receipts also include compensation of employees based abroad. The financial account measures U.S. investment abroad and foreign investment in the United States. The capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers to title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes the capital account transactions will be small in comparison to the current account and financial account.

Table 1.–International Transactions between the United States and France, 2008
($ billions, nominal)

Current Account Balance	**-6.4**
Exports of goods and services from the United States and income receipts from France	73.8
Merchandise	28.6
Services	18.0
Income receipts from U.S. assets[1]	27.2
Imports of goods and services from France and income payments to France	80.4
Merchandise	44.0
Services	17.0
Payments on French-owned U.S. assets[1]	19.2
Unilateral Transfers	0.1
Financial Account Balance	**20.2**
French investment in the United States[2]	-17.6
Direct investment	14.0
Securities besides Treasury securities	-4.8
U.S. investment in France[2]	-57.0
Direct investment	5.9
Private securities[1]	-26.4
Increase in government assets	0.0
Capital Account Transactions, net	**0.0**
Statistical Discrepancy	**-13.7**

Notes:

[1] In the national income and product accounts, the "income" entry of the current account includes certain employee compensation income. Table 1 excludes $47 million of compensation paid by French persons to U.S residents employed temporarily in France, U.S. workers who commute to work in France, and U.S. residents employed by the French embassy, and $118 million of compensation paid by U.S. persons to French residents employed temporarily in the United States, French workers who commute to work in the United States, and French residents employed by the U.S. embassy in France).

[2] Excluding financial derivatives.

Source: Bureau of Economic Analysis, U.S. Department of Commerce, October 20, 2009. Preliminary data.

C. Trends in Current Account Income Flows Between the United States and France

Payments of royalties

As Table 1 displays, the current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. Trade in services includes: transportation of goods; travel by persons and passenger fares; professional services such as management consulting, architecture, engineering, and legal services; financial services; insurance services; computer and information services; and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2008, U.S. persons received approximately $3.7 billion in royalties and license fees from France.[69] In 2006, French persons' payments of royalties and license fees constituted 4.0 percent of all such payments to the United States. France ranked as the seventh largest payor of royalties and license fees among all U.S. trading partners.[70] In 2008, French persons received $4.2 billion in royalties and license fees from the United States.[71] These U.S. payments of royalties and license fees constituted 15.9 percent of all such payments made by U.S. persons. Figure 1 documents the cross-border payments of royalties and license fees between the United States and France since 1986 measured in real 2005 dollars.[72] The aggregate amount of such cross-border flows has grown from less than $1.2 billion in 1986 to $7.3 billion in 2008.

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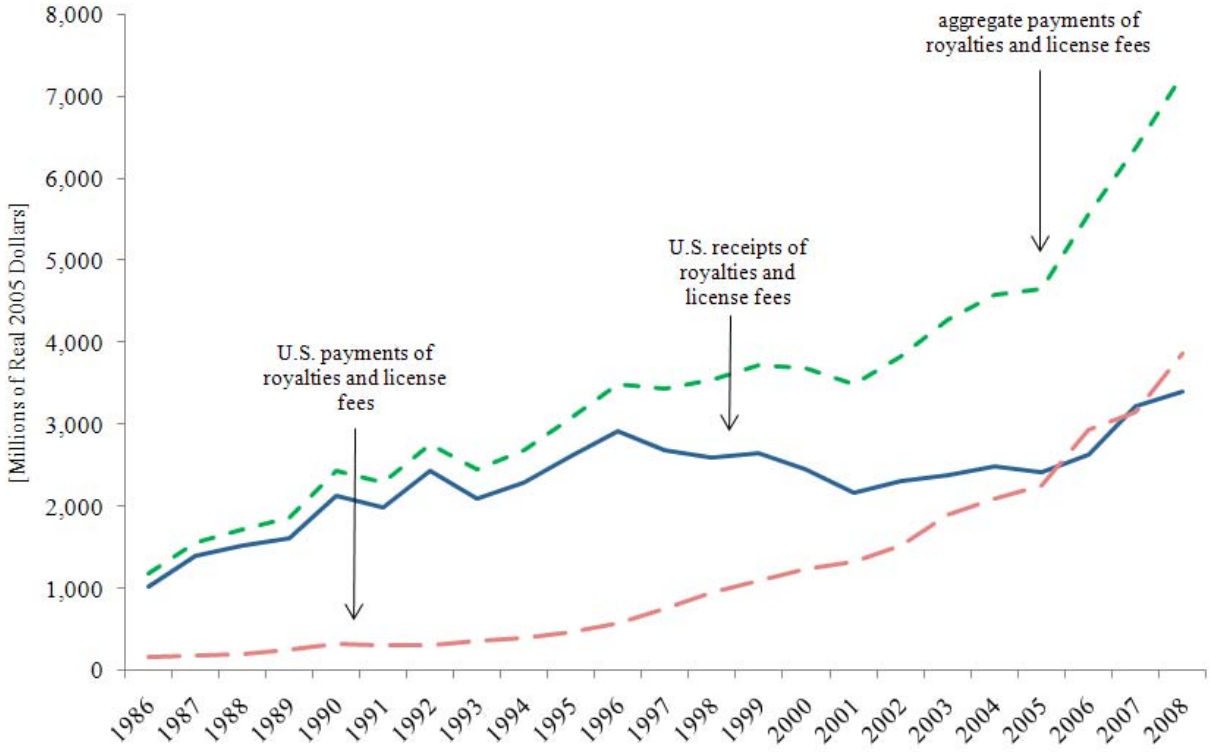
[69] Jennifer Koncz-Bruner and Anne Flatness, "U.S. International Services, Cross-Border Trade in 2009 and Services Supplied Through Affiliates in 2007," *Survey of Current Business*, vol. 89, October 2009, p 22.

[70] *Ibid.*

[71] *Ibid.*

[72] In Figure 1 through Figure 3 a solid line represents payments to the United States from France and a heavy broken line represents payments from the United States to France. Figure 1 and Figure 2 also have a lighter broken line representing the sum of payments from France and from the United States.

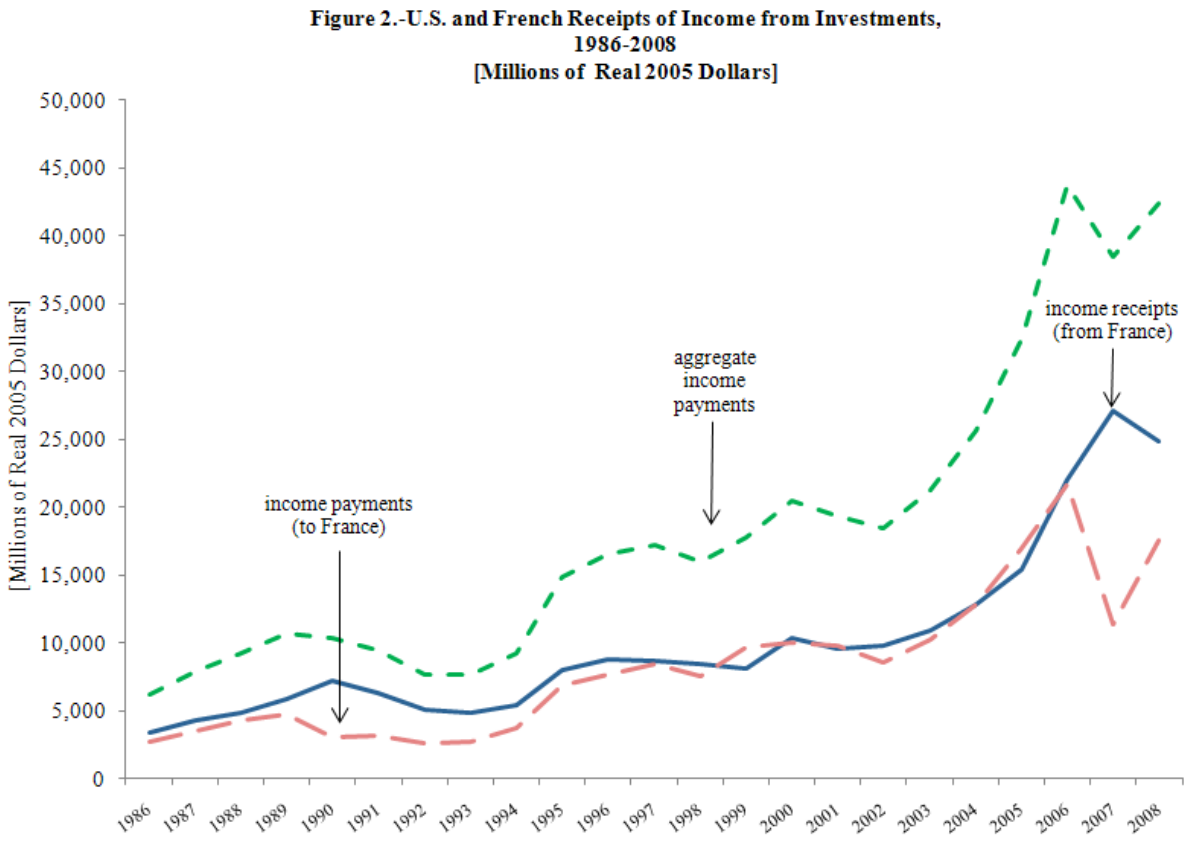
Figure 1.-U.S. and French Payments of Royalties and Licence Fees
1986-2008
[Millions of Real 2005 Dollars]



Income receipts from investments

Overview

Figure 2 shows the growth in cross-border receipts between the United States and France that has occurred in cross-border payments of income from French assets owned by U.S. persons and from U.S. assets owned by French persons. Measured in real dollars, income received by U.S. persons from the ownership of assets in France has increased sevenfold since 1986. Over the same period, income received by French persons from the ownership of assets in United States has also grown more than sixfold.



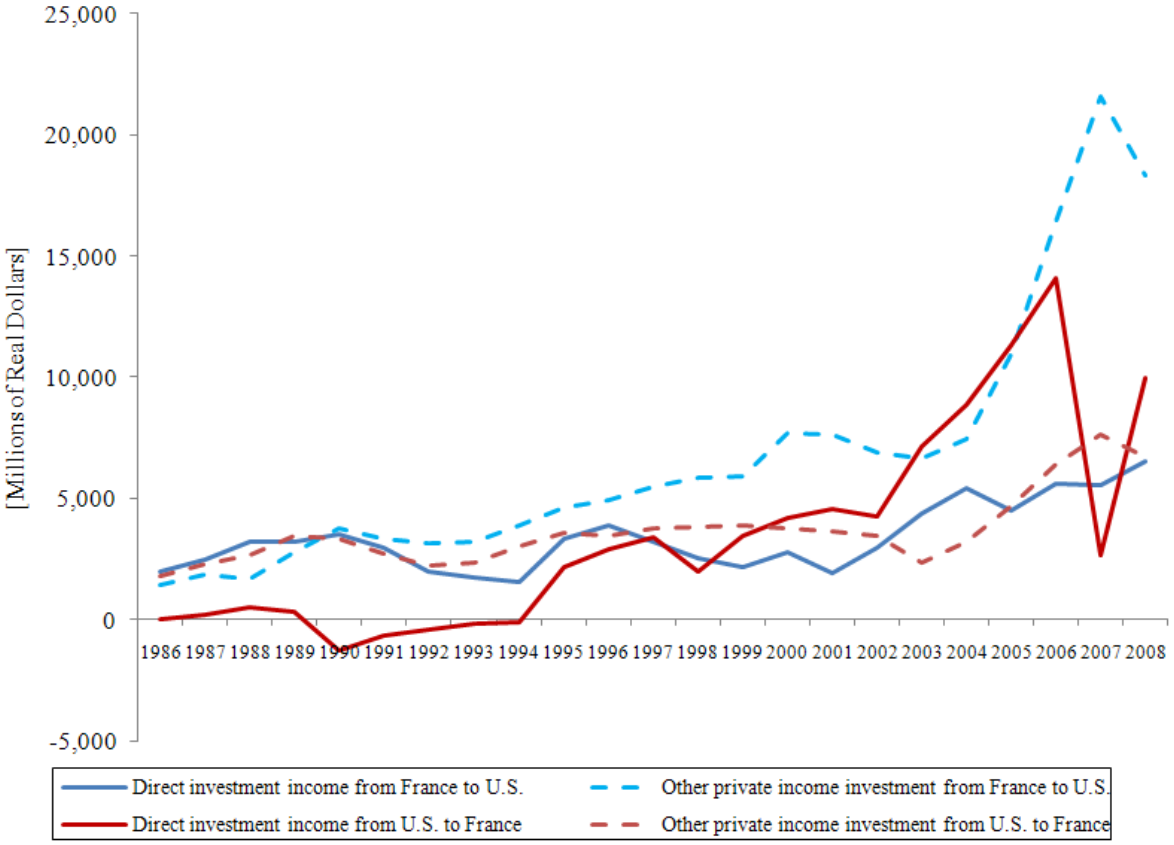
Income from direct investment and income from non-direct investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments, the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

In 2008, the income received by French persons from direct investments in the United States totaled $10.9 billion and the income received by French persons from (non-governmental) and portfolio other non-direct investments in the United States totaled $7.3 billion. French persons also received more than $0.9 billion in income from payments from the U.S. government, largely interest on U.S. government obligations held by French persons.

In 2008, the income of U.S. persons from direct investments in France totaled $7.1 billion. The income received by U.S. persons on their portfolio and other non-direct investments in France ($20.2 billion in 2008), was 173 percent greater than the income received by French persons from (non-governmental) portfolio and other non-direct investments in the United States ($7.3 billion in 2008). Figure 3 records the cross-border income flows from direct and portfolio and other non-direct investments between the United States and France.

Figure 3.-U.S. and French Income from Direct and Non-Direct Investments, 1986-2008
[Millions of Real 2005 Dollars]



D. Trends in the Financial Account Between the United States and France

As discussed above, the current account of international transactions between the United States and France records the current-year flow of receipts from current export of goods and services and the income flows arising from past investments. The financial account of international transactions between the United States and France (the bottom portion of Table 1) measures the change in U.S ownership of French assets and the change in French ownership of U.S. assets. The importance of the financial account, as documented in the preceding discussion, is that ownership of assets abroad generates future receipts of income. Due to the global economic downturn, the value of aggregate cross-border investment between the United States and France declined significantly in 2008, though in recent quarters the value aggregate cross-border investment has begun to rise.[73] As Table 1 documented, in 2008, U.S. persons decreased asset holding in France by $57 billion while French persons decreased their ownership of U.S. assets by $17.6 billion. Figure 4, below, shows the annual change in U.S.-owned French assets and the annual change in French-owned U.S. assets.[74]

[73] The Bureau of Economic Analysis prepares estimates of the value of cross-border investment based on current market prices. Accordingly, the sharp decline in the value of cross-border investment in 2008 is primarily a result of the global decline in the market value of financial assets associated with the 2008 financial crisis.

[74] In Figure 4 through Figure 6 a solid line indicates the net acquisition (purchase of assets, purchase of securities, bank deposit, or extension of credit) by U.S. persons of assets in France, and a broken line indicates the net acquisition by French persons of U.S. assets. A negative number represents a net disposition of such assets.

Figure 4.-U.S. and French Financial Account Carriage Return Annual Change in Assets Owned (Excluding Financial Derivatives), 1986-2008 [Millions of Real 2005 Dollars]

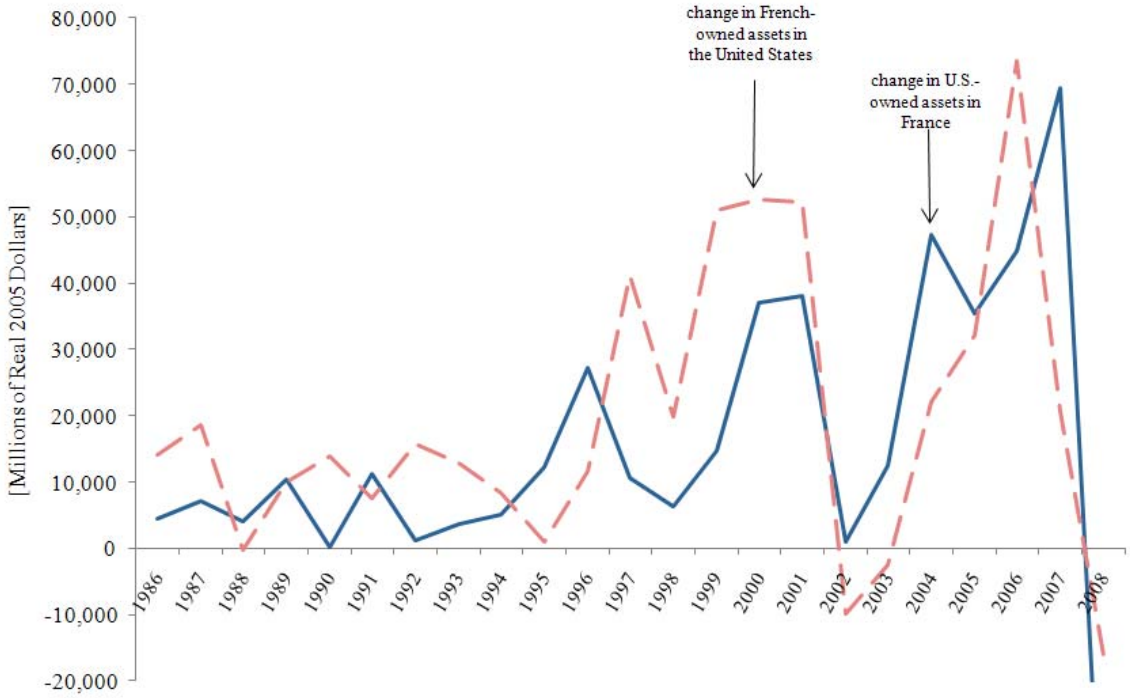


Figure 5 and Figure 6 report the two largest components of these annual changes in asset ownership: direct investment and portfolio acquisition of securities (one component of non-direct investment). Figure 5 reports the annual change in U.S. direct investment in France and the annual change in French direct investment in the United States since 1986. Almost all years since 1986 show an increase in the amount of direct investment in assets of the one country by investors in the other country. Of note, both the value of U.S. direct investment in France and the value of French direct investment in the United States continued to increase through 2008, even as the value of aggregate investment declined. The changes measured in direct investment occur because of increases or decreases in equity investment, changes in intra-company debt, the reinvestment of earnings, and currency valuation adjustments.

Figure 5.-Annual Change in U.S. and French Direct Investment 1986-2008 [Millions of Real 2005 Dollars]

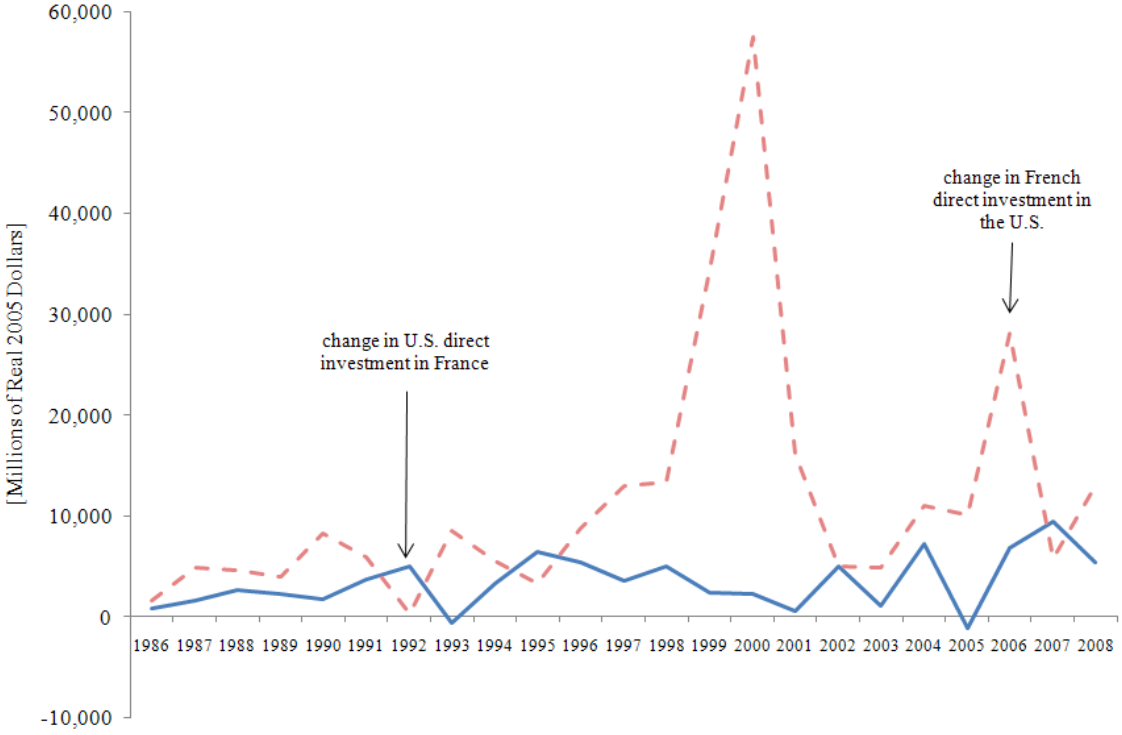
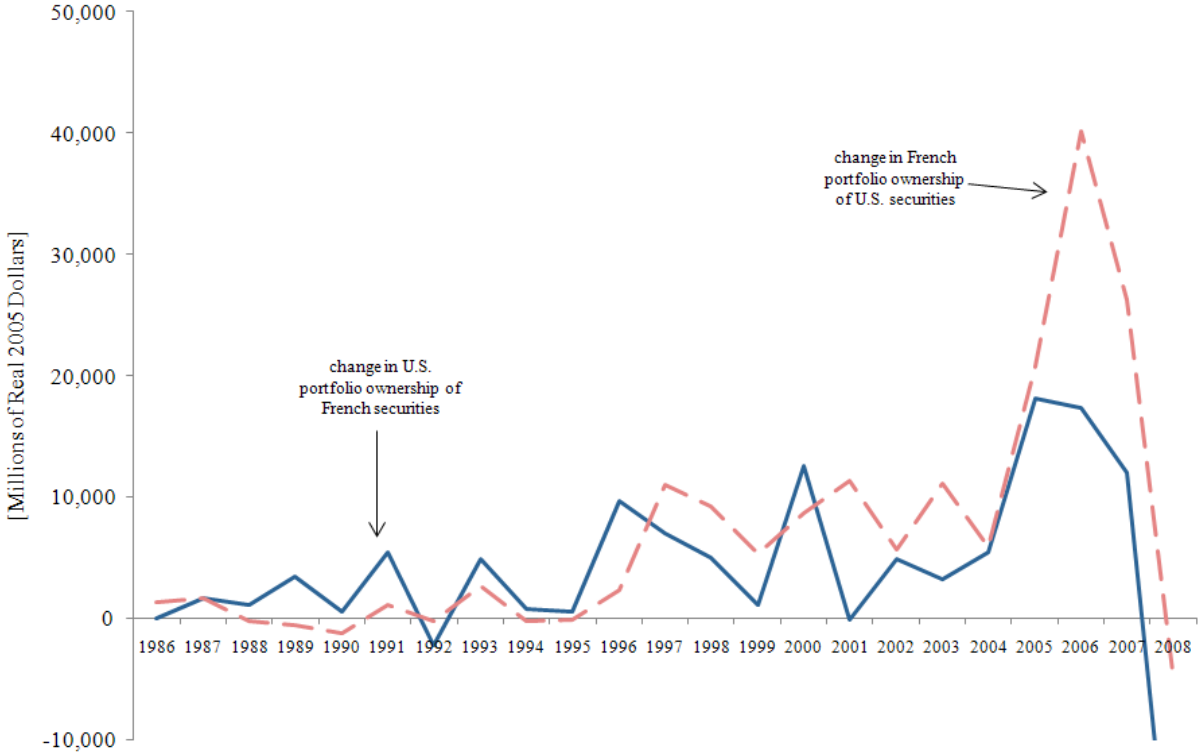


Figure 6.-Annual Change in U.S. and French Ownership of Portfolio Securities, 1986-2008
[Millions of Real 2005 Dollars]



Total direct investment by U.S. persons in France is large. Measured on an historical cost basis,[75] the value of U.S. direct investment in France as of the end of 2008 was $75.0 billion. The value of French direct investment in the United States at the end of 2008 was $163.4 billion, 7.2 percent of total foreign direct investment in the United States.[76]

Non-direct investment generally may be thought of as consisting of two components, portfolio investment, that is, the purchase of securities (stocks and bonds), and lending activities. Figure 6 reports the annual change in the holdings of French securities (including French governmental securities) by private U.S. persons and the annual change in the holdings of U.S. securities (other than Treasury securities) by private French persons. In 2008, U.S. holdings of French stocks and bonds had a year-end estimated value of $243 billion.[77] Of this total, French

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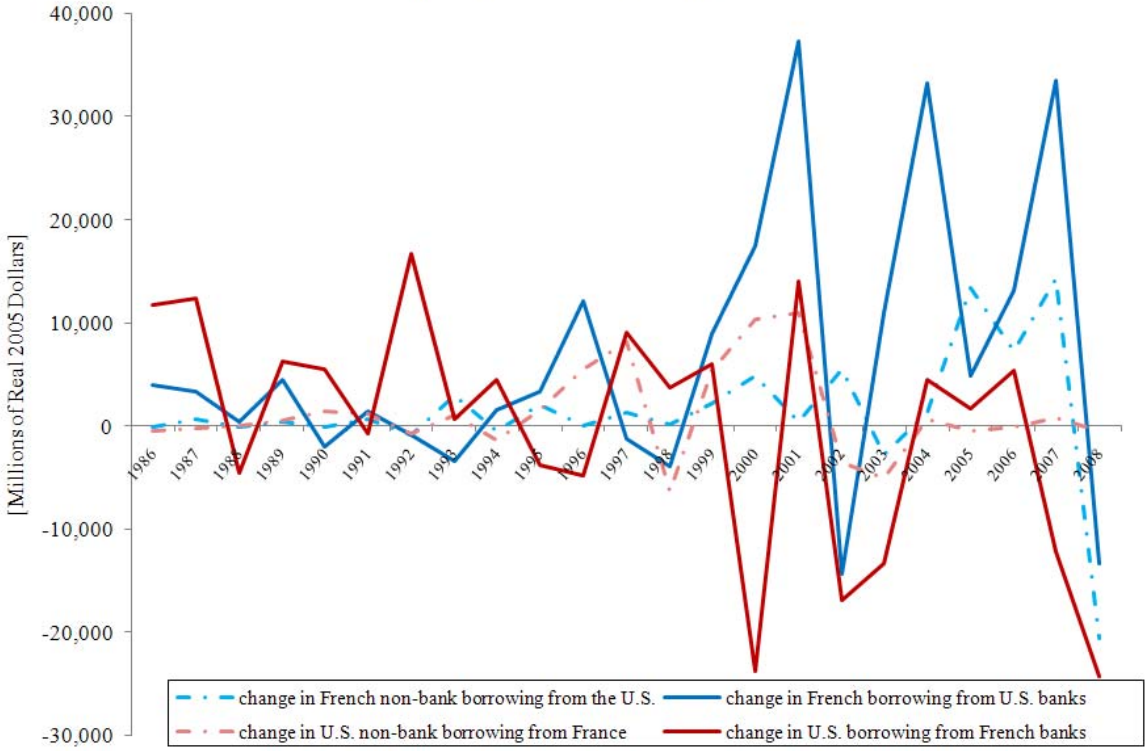
[75] The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

[76] Jeffrey Lowe, "Direct Investment 2006-2008: Detailed Historical-Cost Positions and Related Capital and Income Flows," *Survey of Current Business*, vol. 89, September 2009.

[77] Elena L. Nguyen, "The International Investment Position of the United States at Year End 2006," *Survey of Current Business*, vol. 89, July 2009, p. 10. The Bureau of Economic Analysis

stocks account for $196.5 billion (down from $347.8 billion in 2007) and French bonds account for $46.5 billion.[78] Among U.S. holdings of foreign stocks, the value of French stock held is fourth after holdings of U.K. equities, Japanese equities, and Canadian equities by U.S. persons.[79] French holdings of U.S. securities (other than Treasury securities) at the end of 2008 totaled $88.4 billion of U.S. corporate stocks (down from $144 billion in 2007) and $72.0 billion of U.S. corporate bonds and the bonds of certain Federal agencies (other than general obligation Treasury bonds). In the case of equities, these holdings comprised 4.8 percent of total foreign holdings of U.S. equities. In the case of bonds, these holdings comprised 2.5 percent of total foreign holdings of such bonds.[80]

Figure 7.-Annual Change in U.S. Bank and Non-Bank Lending to French Persons and French Bank and Non-Bank Lending to U.S. Persons [Millions of Real 2005 Dollars]



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estimates the value of equity holdings based on market prices. Accordingly, the approximately 40 percent declines in both the value of French holdings of U.S. stocks and the value of U.S. holdings of French Stocks that occurred in 2008 reflects the global decline in stock prices, and are in line with the 40 percent drop in the S&P 500 index between year-end 2007 and year-end 2008.

[78] *Ibid.*

[79] *Ibid.*

[80] *Ibid.*

Lending activities, aside from the sale of debt securities, constitute the remaining source of non-direct cross-border investment. When a U.S. bank makes a loan to a foreign person abroad (including a foreign subsidiary), the U.S. bank is making a foreign investment. Non-bank U.S. persons also make foreign investments through lending activities. When a non-bank U.S. person makes a deposit in a foreign bank, the non-bank U.S. person is making a foreign investment. Likewise if a U.S. business draws on a line of credit from a bank in France, the French bank is making an investment in the United States. Such deposit and borrowing activity can be quite variable and changes in exchange rates and business activity abroad may lead to substantial variability in the annual level of such activity. Figure 7 reports the changes in lending by U.S. banks and non-banking U.S. persons to French persons since 1986.

E. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above report the amount of direct investment in France by U.S. persons and the amount of direct investment in the United States by French persons. Data from tax returns reflect the magnitudes of cross-border investment and trade and income flows reported above.[81] In 2006, U.S. corporations with French parent companies had $12.9 billion of income subject to tax and paid $4.2 billion in U.S. Federal income taxes.[82] U.S. corporations, including U.S. parent companies of French controlled foreign corporations, reported the receipt of $4.5 billion of dividends from French corporations in 2005.[83] Of the $4.5 billion in dividends reported, approximately $1.0 billion reflected the grossed up value of net dividends to account for deemed taxes paid to France. U.S. corporations recognized about $5.2 billion in taxable income originating in France, including the dividend amounts just cited. This income was subject to an average French corporate income tax rate of approximately 33.9 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

Data for withholding taxes from 2005 show that the United States collected approximately $503 million through withholding of taxes on payments to France.[84] Data on withholding taxes may not be an accurate indicator of cross-border investment and income flows, however, because a taxpayer can often control the amount and timing of tax paid, since withholding tax is only paid when dividends are repatriated to the home country.

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[81] The data reported below are classified according to the geographical location of the direct payor and may not capture the full extent of tiered activity.

[82] James R. Hobbs, "Foreign Controlled Domestic Corporations, 2006," *Statistics of Income Bulletin*, Summer 2009, pp. 101-45.

[83] Melissa Costa, "Corporate Foreign Tax Credit, 2005," *Statistics of Income Bulletin*, Summer 2009, pp. 146-96.

[84] Scott Lutrell, "Foreign Recipients of U.S. Income, 2005," *Statistics of Income Bulletin*, Winter 2009, pp. 99-109.

F. Analyzing the Economic Effects of Income Tax Treaties

Tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources results and economic growth in both countries is enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and French income tax liabilities.

Generally, a treaty-based reduction in withholding rates directly reduces U.S. tax collections in the near term on payments from the United States to foreign persons, but increases U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this dampening of collections on payments to foreign persons and related decrease in foreign tax credits begins to reverse. The proposed protocol's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to France. Over the longer term, the withholding tax rate changes coupled with other changes in the proposed protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of withholding taxes, or any other change in a treaty, would account for both tax and nontax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is also an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED PROTOCOL

Article I. Resident

The assignment of a country of residence under income tax treaties is important because the benefits of treaties generally are available only to a resident of one of the treaty countries as that term is defined in treaties. Issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries. The proposed protocol makes changes to Article 4 (Resident) of the present treaty that in general make the rules conform more closely to the rules of other recent U.S. income tax treaties and protocols.

Under the present treaty, a resident of a treaty country includes, among other entities, a U.S. regulated investment company ("RIC"), a U.S. real estate investment trust ("REIT"), a U.S. real estate mortgage investment conduit ("REMIC"), a French "société d'investissement à capital variable" ("SICAV), and any similar investment entities agreed upon by the competent authorities of the treaty countries. The proposed protocol adds to this list two other French entities that were not recognized under French law at the time the 2006 protocol was signed – a "société d'investissement immobilier cotée" ("SIIC") and a "société de placement à prépondérance immobilière à capital variable" ("SPPICAV").

The Technical Explanation[85] notes that the proposed protocol retains the present treaty's rule, also found in other recent U.S. income tax treaties, that U.S. RICs, REITs, and REMICs, which are generally subject to U.S. tax only to the extent they do not satisfy certain requirements for distributing their profits currently, are treated as residents and therefore are accorded treaty benefits. The Technical Explanation notes that these entities may be regarded as "liable to tax" in the United States, a requirement for being treated as a resident under the treaty, because of the current distribution requirements and the imposition of tax if those requirements are not met.

The proposed protocol deletes certain of the present treaty's special residence rules for partnerships and similar pass-through entities, estates, and trusts. In their place, the proposed protocol provides a special rule for French qualified partnerships and includes a rule for fiscally transparent entities, which are entities that are not subject to tax at the entity level, that are similar to rules found in other recent U.S. income tax treaties. One difference from recent U.S. treaties is the addition of a requirement, described below, that, addresses situations in which an item of income, profit, or gain is derived through a fiscally transparent entity formed or organized in a third country.

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[85] Department of the Treasury Technical Explanation of the Protocol Signed at Paris on January 13, 2009 Amending the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Paris on August 31, 1994, as Amended by the Protocol Signed on December 8, 2004 (hereinafter referred to as the "Technical Explanation").

According to the Technical Explanation, the special rule for French qualified partnerships is intended to ensure that those partnerships remain eligible for treaty benefits to the same extent they were eligible for benefits under one of the present treaty's special residence rules that is deleted by the proposed protocol. Under the new special rule, an item of U.S.-source income paid to a French qualified partnership is considered derived by a resident of France to the extent that the income is included currently in the taxable income of a shareholder, an associate, or another member that is otherwise treated as a resident of France under the provisions of the treaty. A French qualified partnership is a partnership (1) that has its place of effective management in France, (2) that has not elected to be taxed in France as a corporation, (3) the tax base of which is computed at the partnership level for French tax purposes, and (4) all of the shareholders, associates, or other members of which are liable to tax under French tax law in respect of their shares of that partnership's profits.

The new rule for fiscally transparent entities provides that for purposes of applying the treaty, an item of income, profit, or gain derived through an entity that is fiscally transparent under the laws of either treaty country and that is formed or organized in either treaty country or in a country that has concluded with the treaty country from which the income, profit, or gain is derived an agreement including an exchange of information provision intended to prevent tax evasion is considered to be derived by a resident of a treaty country to the extent that the item is treated for purposes of the tax law of that treaty country as the income, profit, or gain of a resident. The threshold requirement that a third country in which a fiscally transparent entity is formed or organized must have concluded with the treaty country from which the entity has derived income an agreement including an exchange of information provision intended to prevent tax evasion is not included in other recent U.S. tax treaties.

Entities that are fiscally transparent for U.S. tax purposes include partnerships, common investment trusts under Code section 584, grantor trusts, and limited liability companies that are treated as partnerships or as disregarded entities under U.S. internal law.

The Technical Explanation notes that when income is derived through an entity that is fiscally transparent in one or more countries, the risk of double taxation or double nontaxation is relatively high because countries may have different views about whether an entity is fiscally transparent. The intention of the new rules for fiscally transparent entities, according to the Technical Explanation, is to eliminate technical disputes that had arisen under the present treaty's rules for partnerships and similar entities and to adopt, with the modification described previously for income derived through a fiscally transparent entity formed or organized in a third country, the current U.S. tax treaty approach.

The Technical Explanation provides the following illustration of the application of this special rule. XCo, which is an entity organized in Country X, is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, and is treated for U.S. tax purposes as fiscally transparent, receives French-source income. Country X has not concluded with France an agreement including an exchange of information provision intended to prevent tax evasion. Accordingly, the U.S. shareholder is not considered to have derived French-source income.

To illustrate the general application of the rule for fiscally transparent entities, the Technical Explanation describes the consequences under the proposed protocol when a

corporation resident in France distributes a dividend to a U.S. entity. If the U.S. entity is fiscally transparent for U.S. tax purposes, the dividend is considered derived by a resident of the United States to the extent that U.S. tax law treats one or more U.S. residents as deriving the dividend income. If the U.S. entity is a partnership, the partners of the partnership generally are the persons whom U.S. tax law treats as deriving the dividend income through the partnership. If those partners are U.S. residents, they are therefore generally eligible for treaty benefits in respect of their shares of the dividend paid by the French resident corporation. If those partners are not U.S. residents for U.S. tax purposes, they may not claim treaty benefits for the dividend. They may, however, be eligible for the benefits of a treaty between France and the country of which they are residents. The Technical Explanation notes that if the dividend from the French corporation is instead paid to a U.S. entity that is classified as a corporation (rather than a partnership) for U.S. tax purposes, the dividend is considered derived by a resident of the United States because the U.S. corporation is treated under U.S. tax law as a resident of the United States and as deriving the income.

The Technical Explanation notes that the consequences described in the above examples would be the same even if the entity receiving the French-source dividend were treated differently under French tax law – that is, even if in the U.S. partnership example above that entity were treated as not fiscally transparent under French tax law or, in the U.S. corporation example above, even if the entity were treated as fiscally transparent under French tax law.

The Technical Explanation also illustrates the application of the fiscally transparent entities rule in a circumstance in which a French-source item of income is paid to an entity organized in France rather than, as in the example above, in the United States. In this circumstance, if U.S. tax law treats the French entity as a corporation and the entity is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, the income received by the entity is not considered derived by the U.S. shareholder even if the entity is treated as fiscally transparent under French tax law. Under U.S. law, the French corporation is treated as a separately taxable entity, and the U.S. shareholder of that corporation generally is not subject to U.S. tax on income received by the entity until the shareholder receives a distribution of the income.

The fiscally transparent entities rule applies to trusts that are fiscally transparent in either the United States or France. Thus, according to the Technical Explanation, if X, a resident of France, creates a U.S. revocable trust of which third country residents are the beneficiaries, the trust's income would be treated as derived by a resident of France only to the extent French tax law treats X as deriving the income for French tax purposes (through, for instance, rules similar to the U.S. grantor trust rules).

The fiscally transparent entities rule is subject to the saving clause. Consequently, the rule does not prevent either treaty country from taxing an entity that is treated as a resident of that country under its own tax law. For instance, according to the Technical Explanation, if a U.S. limited liability company with French resident members elects to be taxed as a corporation for U.S. tax purposes, the United States may tax the limited liability company on its worldwide income on a net basis even if France treats the entity as fiscally transparent.

Article II. Dividends

Overview

The proposed protocol replaces Article 10 (Dividends) of the present treaty. The new article generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable 15-percent maximum withholding rate and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Like several other recent treaties and protocols, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. As in the present treaty, special rules apply to dividends received from a RIC, a REIT, and a SICAV; under the proposed protocol, these rules are extended to a SIIC and a SPPICAV.

Internal taxation rules

United States.–The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate foreign direct investment.

A REIT is a corporation, trust, or association that is subject to the corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is generally treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, a distribution from a REIT is generally treated as gain from the disposition of a U.S. real property interest that must be recognized by a nonresident alien individual or a foreign corporation to the

extent that the distribution is attributable to gain from the sale or exchange of a U.S. real property interest by the REIT.[86]

A REIT is generally organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law.

U.S. internal law also generally treats a RIC as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Dividends paid by a RIC are generally treated as dividends received by the payee, and if the RIC distributed substantially all of its income, it generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2010, net short-term, capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has such net capital gains.[87] Nonresident aliens and foreign corporations are generally not subject to tax on capital gains. However, a distribution by a RIC to a nonresident alien or a foreign corporation before January 1, 2010, is treated as gain recognized by such person from the sale or exchange of a U.S. real property interest to the extent such gain is attributable to gain from sales or exchanges of U.S. real property interests.[88]

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[89] may generally designate a dividend it pays prior to January 1, 2010, as derived from such interest income, to the extent of such

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[86] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Code sec. 897(h)(1). Such distributions are treated as dividends under U.S. internal law.

[87] Code sec. 871(k)(2)(C).

[88] Code sec. 897(h)(1), (4)(A)(i)(II), (4)(A)(ii).

[89] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under Code section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of Code sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under Code section 871(h)(4); and (4) any interest-related dividend from another RIC.

income.[90] Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to such interest income.

France.–France generally imposes withholding tax at a rate of 25 percent on the gross amount of dividends paid to nonresidents.[91]

Proposed protocol limitations on internal law

In general.–Consistent with the U.S. and OECD Model treaties, and the present treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other treaty country may be taxed in such other country under the proposed protocol. Such dividends also may be taxed by the country in which the payor company is resident, but the rate of such tax is limited. Source-country taxation of dividends (i.e., taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower, five-percent rate applies if the beneficial owner of the dividend is a company that owns shares representing at least 10 percent of the voting power in the dividend-paying company.

The term "beneficial owner" is not defined in the present treaty or proposed protocol, and thus is defined under the internal laws of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, special rules apply to a company holding shares through a fiscally transparent entity, such as a partnership, for purposes of determining whether dividends should be treated as having been derived by a resident of a treaty country.

In addition, as explained in greater detail below, the proposed protocol provides a zero rate of withholding tax with respect to certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as "direct dividends").

Zero rate for direct dividends.–Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. Under the present treaty, a withholding tax of up to five-percent may be imposed on such dividends. The 80-percent ownership requirement under the proposed protocol may be satisfied by either direct or indirect ownership (through one or more residents of either treaty country).

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[90] Code sec. 871(k)(1)(C).

[91] Under the EU Parent-Subsidiary Directive, there is no withholding tax on dividends paid by a resident company to a qualifying EU parent company, if, among other conditions, the recipient holds 10 percent or more of the shares of the subsidiary for at least two years. E&Y, p. 296.

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than would otherwise apply under the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must either: (1) meet the "publicly traded" test of the limitation-on-benefits article; (2) meet the ownership and base erosion tests *and* satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) meet the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

The Technical Explanation states that these additional restrictions are intended to prevent companies from reorganizing to become eligible for the zero rate. As an example, the Technical Explanation describes a situation in which a company resident in a third country that does not have a zero-rate treaty provision with the United States might contribute the stock of a wholly owned U.S. subsidiary to a wholly owned French subsidiary to secure the benefit of the zero rate on a dividend from the U.S. subsidiary. The Technical Explanation expresses the concern that in such a case, treaty shopping would be encouraged because the French company satisfies the active trade or business test with respect to the dividend. For this reason, the proposed protocol does not allow the benefits of the zero rate to be claimed by a company that meets only the active trade or business test of the limitation-on-benefits article.

The proposed protocol modifies the application of the derivative benefits test in the context of the zero-rate provision, to ensure that certain joint ventures may qualify for the zero rate. Specifically, in determining whether a shareholder of a dividend-receiving company is an equivalent beneficiary, each such shareholder is treated as owning shares in the dividend-paying company with the same percentage voting power as the shares held by the dividend-receiving company for purposes of determining entitlement to the zero rate. Thus, as the Technical Explanation describes, a French company owned 49 percent by another French company, and 51 percent by a company resident in another EU country that has an identical zero-rate provision with the United States, qualifies via the derivative benefits test for the zero rate on a dividend received from a U.S. company, despite the fact that neither shareholder of the dividend-receiving company meets the 80-percent ownership test individually.

The Technical Explanation also provides some guidance as to how the competent authority discretion to grant the benefits of the zero-rate provision is intended to be exercised. Specifically, the Technical Explanation states that the benefits will be granted with respect to an item of income if the competent authority of the source country (i.e., the country in which the income arises) determines that the establishment, acquisition or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

Dividends paid by RICs, REITs, SICAVs, SIICs, and SPPICAVs.–Consistent with the present treaty, the proposed protocol generally denies the five-percent rate of withholding tax to dividends paid by U.S. RICs and REITs and French SICAVs. The proposed protocol includes new terms that extend this treatment to dividends paid by French SIICs and SPPICAVs. In addition, the proposed protocol denies the zero rate of withholding tax to dividends paid by RICs, REITs, SICAVs, SIICs, and SPPICAVs.

Under the proposed protocol, the 15-percent rate of withholding applies to dividends paid by either a RIC or a SICAV. The 15-percent rate of withholding may also apply to dividends paid by REITs, SIICs, and SPPICAVs, but only if one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or pension fund holding an interest of not more than 10 percent in the REIT, SIIC, or SPPICAV; (2) the dividend is paid with respect to a class of shares that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT, SIIC, or SPPICAV's shares; or (3) the beneficial owner of the dividend holds an interest in the REIT, SIIC, or SPPICAV of not more than five percent. To qualify for the 15-percent withholding rate, a REIT must be "diversified" (i.e., the value of no single interest in real property held by the REIT exceeds 10 percent of the total interest of the REIT in real property). Consistent with the U.S. Model treaty, the proposed protocol provides that, in determining if a REIT is diversified, (1) foreclosure property is not considered an interest in real property and (2) a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The Technical Explanation indicates that the restrictions on the availability of the lower rates are intended to prevent the use of RICs and REITs to gain unjustifiable U.S. tax benefits, or the use of SICAVs, SIICs, or SPPICAVs to gain inappropriate French tax benefits. For example, a company resident in France could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends distributed with respect to those shares. Absent these restrictions, such a company instead might purchase 10 percent or more of the interests in a RIC and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC – transforming portfolio dividends generally subject to a 15 percent withholding tax into direct investment dividends subject to a five percent withholding tax or eligible for elimination of withholding tax.

Similarly, the Technical Explanation provides an example of a resident of France directly holding real property and required to pay U.S. tax, either at a 30-percent rate on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Definitions, special rules, and limitations.–Consistent with the present treaty, the proposed protocol generally defines "dividends" as income from shares, "jouissance" shares or rights, mining shares, founders' shares, or other rights (not being debt claims), participating in profits, as well as other amounts that are subjected to the same tax treatment as income from shares by the source country (e.g., constructive dividends). The term "dividends" also includes income from arrangements, including debt obligations, carrying the right to participate in profits. In addition, the Technical Explanation states that a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the underlying debt is recharacterized as equity under the laws of the source country.

Consistent with the present treaty, the withholding rate reductions do not apply under the proposed protocol if (1) the dividend recipient carries on business through a permanent establishment in the source country or performs in the source country independent personal

services from a fixed base located in that country, and (2) the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such cases, dividends effectively connected to the permanent establishment or the fixed base are taxed as business profits (Article 7) or income from independent personal services (Article 14), as the case may be.

Together, paragraphs 8 and 9 of Article 10 of the treaty, as revised by the proposed protocol, allow each treaty country to impose a branch profits tax (at a rate of up to five percent) on a company that (1) has business profits attributable to a permanent establishment in such country, (2) derives income from real property in such country that is taxed on a net basis under the treaty (as amended by the proposed protocol), or (3) realizes gains taxable in such country under the treaty (as amended by the proposed protocol). In the case of the United States, the branch profits tax may only be imposed on the portion of such profits or income that represents the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (Code section 884). In the case of France, the branch profits tax may only be imposed on the portion of the aforementioned items of income and profits that is included in the base of the French withholding tax in accordance with the provisions of Article 115 "quinquies" of the French tax code. The proposed protocol provides for an exemption from branch profits tax in cases in which limitation-on-benefits requirements parallel to those applicable to the zero-rate provision for dividends are satisfied. These rules are consistent with the U.S. Model treaty.

Consistent with the U.S. and OECD Model treaties and the present treaty, the proposed protocol prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country, unless such dividends are paid to a resident of the first country or are attributable to a permanent establishment or fixed base in such country. For example, the United States may not impose a secondary withholding tax on dividends paid by a French resident company unless such dividends (1) are paid to a U.S. resident or (2) are attributable to profits the French company derives from a permanent establishment or fixed base in the United States.

Relation to other articles

The Technical Explanation notes that the saving clause of paragraph 2 of Article 29 of the treaty (Miscellaneous Provisions) (as amended by the proposed protocol) permits the United States to tax dividends received by its residents and citizens as if the treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 30 of the treaty (Limitation on Benefits), as amended by the proposed protocol.

Article III. Royalties

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on the gross amount of U.S.-source royalties paid to nonresident

alien individuals and foreign corporations. U.S.-source royalties include royalties for the use of, or right to use, intangible property in the United States.

France

France imposes a 33⅓-percent withholding tax on the gross amount of royalties paid to nonresidents.

Proposed protocol limitations on internal law

The proposed protocol revises Article 12 (Royalties) of the present treaty. Consistent with the U.S. and OECD Model treaties, the proposed protocol provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country are exempt from taxation in the source country. By contrast, under the present treaty, the source country may impose up to a five-percent withholding tax on gross royalty payments.

In all material respects, the other provisions of Article 12 (Royalties) are the same as those in the present treaty. However, these provisions have been renumbered and realigned. Thus, consistent with the present treaty, the term "royalties" expressly includes consideration for the use of software. The express inclusion of payments for the use of software in the definition of royalties differs from most treaties, as well as the U.S. and OECD Model treaties, in which such consideration is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment. Generally, the primary factor in determining whether such consideration is treated as royalties or as business profits is the nature of the rights transferred.

Article IV. Capital Gains

Article 13 (Capital Gains) of the present treaty provides rules for the taxation of gains from the sale of property by a resident of a treaty country. Paragraph 5 of Article 13 (Capital Gains) of the present treaty, through a cross-reference to paragraph 4(c) of Article 12 (Royalties) of the present treaty, provides that gains derived from the alienation of any such right or property that is contingent on the productivity, use, or further alienation thereof and is covered under the definition of a "royalty" in paragraph 4 is taxable under Article 12 (Royalties). The proposed protocol deletes old paragraph 5 of the present treaty and replaces it with a new paragraph 5 that is in all material respects the same as old paragraph 5. The sole revision is a conforming change to update the cross-reference to Article 12 (Royalties) so that it now references paragraph 2(b) as opposed to paragraph 4(c) of Article 12 (Royalties).

Article V. Artistes and Sportsmen

Article V of the proposed protocol modifies Article 17 (Artistes and Sportmen) of the present treaty to refer to the current currency, euros, rather than to French francs.

Article VI. Pensions

Under Article 18 (Pensions) of the present treaty, payments arising under the social security legislation or similar legislation of one of the treaty countries to a resident of the other

treaty country generally are taxable only in the country in which the payments arise. Under the saving clause of the present treaty (paragraph 2 of Article 29), with certain exceptions the United States may tax its citizens as if the treaty had not come into effect. The saving clause does not, however, affect the benefits conferred under the exclusive source country tax rule of Article 18. The proposed protocol clarifies that this exclusive source country tax rule applies to payments arising under France's social security legislation made not only to residents of the United States, but also to citizens of the United States who are residents of France.

Article VII. Other Income

The proposed protocol replaces Article 22 (Other Income) of the present treaty to conform to the corresponding U.S. Model Treaty provision. Article 22 assigns taxing jurisdiction over items of income beneficially owned by a resident of one of the treaty countries and not dealt with in the other articles of the treaty. The general rule is that such items are taxable only in the country of residence. This right of taxation applies whether or not the residence state exercises its right to tax the income covered by the article.

An item of income is dealt with in another article if it is the type of income described in the article and, in most cases, if it has its source in one of the treaty countries. For example, royalty income that is beneficially owned by a resident of a treaty country is dealt with in Article 12 (Royalties) if the royalty income arises in the other treaty country, but not if the royalty income arises in a third country. However, profits derived in the conduct of a business are dealt with in Article 7 (Business Profits) whether or not they have their source in one of the treaty countries.

According to the Technical Explanation, examples of types of items of income covered by Article 22 include income from gambling, punitive (but not compensatory) damages, and covenants not to compete. Article 22 also applies to income from a variety of financial transactions, in cases in which such income does not arise in the course of the conduct of a trade or business. For example, income from notional principal contracts and other derivatives would be covered if derived by persons not engaged in the business of dealing in such instruments, unless such instruments were used to hedge risks arising in a trade or business. It would also apply to securities lending fees derived by an institutional investor. In most cases, guarantee fees paid within an intercompany group would be covered by Article 22, unless the guarantor is engaged in the business of providing such guarantees to unrelated parties.

Article 22 also applies to items of income that are not dealt with in another article because of their source, character, or some other attribute. For example, Article 11 (Interest) addresses only the taxation of interest arising in one of the treaty countries. Therefore, interest arising in a third country that is not attributable to a permanent establishment is subject to Article 22.

Distributions from partnerships are not generally dealt with under Article 22 because partnership distributions generally do not constitute income. Under the Code, partners include in income annually their distributive share of partnership income, and partnership distributions themselves generally do not give rise to income. U.S. law provides the same result with respect to distributions from trusts. Trust income and distributions that, under the Code, have the

character of the associated distributable net income generally are covered by another article of the present treaty or the proposed protocol.

The general rule of residence taxation does not apply to income, other than income from real property as defined in paragraph 2 of Article 6 (Income from Real Property), if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment situated therein, or performs in that other country independent personal services from a fixed base situated therein, and the income is attributable to such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) apply. Therefore, income arising outside the United States that is attributable to a permanent establishment maintained in the United States by a resident of France, or attributable to independent personal services performed by a resident of France from a fixed base in the United States, generally is taxable by the United States under the provisions of Article 7 or 14. This conclusion is true even if the income is sourced in a third country.

Article 22 is subject to the saving clause in paragraph 2 of Article 29 (Miscellaneous Provisions). Accordingly, U.S. citizens who are residents of France will continue to be taxable by the United States on income to which Article 22 applies, including relevant third-country income. This article is also subject to the provisions of Article 30 (Limitation on Benefits). Thus, if a resident of France earns income that falls within the scope of paragraph 1 of Article 22, but that is taxable by the United States under U.S. law, the income is exempt from U.S. tax under the provisions of Article 22 only if the resident satisfies one of the tests of Article 30 for entitlement to benefits.

Article VIII. Relief from Double Taxation

Paragraph 1 of Article 24 (Relief from Double Taxation) of the present treaty generally covers the circumstances in which a U.S. citizen or resident may be entitled to a foreign tax credit. Likewise, paragraph 2 of Article 24 (Relief from Double Taxation) covers the circumstances in which a French resident avoids double taxation. So that the U.S. and French alternat are consistent, the proposed protocol renumbers both the English and French versions of the U.S. alternat to the present treaty so that paragraph 1 of Article 24 (Relief from Double Taxation) is renumbered as paragraph 2, and paragraph 2 is renumbered as paragraph 1.

The proposed protocol revises new subparagraph 1(a)(iii), as renumbered by the proposed protocol, to delete the reference to Article 12 (Royalties). This change reflects the proposed protocol's revision to paragraph 1 of Article 12 (Royalties), which provides exclusive residence taxation for royalties arising in one treaty country that are beneficially owned by a resident of another treaty country. As a result of this revision, royalties will be covered under new paragraph 1(a)(iii), as modified by the proposed protocol.

Paragraph 1(b) of Article 24 (Relief from Double Taxation), as renumbered by the proposed protocol, addresses those circumstances in which the beneficial owner of income is an individual who is both a resident of France and a citizen of the United States and is entitled to a foreign tax credit. The proposed protocol makes conforming changes to update cross-references within clause (i) of paragraph 1(b) of Article 24 (Relief from Double Taxation).

Paragraph 1(e)(i) of Article 24 of the present treaty, as renumbered by the proposed protocol, is deleted and replaced by paragraph 4 of Article XIII. New paragraph 1(e)(i) clarifies that companies resident in France are still allowed to elect to be taxed on a worldwide basis subject to a tax credit, instead of applying the general system of exempting foreign business income.

Paragraph 2(c) of Article 24 (Relief from Double Taxation) of the present treaty, as renumbered by the proposed protocol, is deleted. The provision was intended to ensure that French government employees performing government services in the United States who were dual nationals would avoid double taxation. This purpose – the mitigation of double taxation of individuals that are U.S. citizens as well as French nationals – is now accomplished by new paragraph 9 of Article 29 (Miscellaneous Provisions), which provides that remuneration for such persons is taxable only in the United States.

Article IX. Non-Discrimination

Under Article 25 (Non-Discrimination) of the present treaty, a permanent establishment that an enterprise of a treaty country has in the other treaty country may not be subject in that other country to less favorable taxation than the taxation of other enterprises in that other country that engage in the same activities. By cross-reference to Article 10 (Dividends), however, paragraph 2 of Article 25 preserves each treaty country's ability to levy a second level of tax on branch profits at the same rate as the tax that may be imposed on dividends paid by a subsidiary corporation in one treaty country to a parent corporation in the other treaty country. The allowance of a branch profits tax is in paragraph 7 of Article 10 (Dividends) of the present treaty and is moved to paragraph 8 in the proposed protocol. To reflect this change, the proposed protocol updates the cross-reference to Article 12.

In general, Article 25 of the present treaty provides that, for purposes of determining the taxable profits of an enterprise of a treaty country, interest, royalties, and other amounts paid by an enterprise of that treaty country to a resident of the other treaty country must be deductible in the first country under the same conditions as if they had been paid to a resident of that country. By reference to paragraph 7 of Article 12 (Royalties), an exception is allowed to the extent that a royalty amount exceeds an arm's-length amount. The proposed protocol renumbers paragraph 7 of Article 12 as paragraph 5. The proposed protocol updates the cross-reference to Article 10 to reflect this renumbering.

Article X. Mutual Agreement Procedure

Like other U.S. income tax treaties, the present treaty includes provisions in Article 26 (Mutual Agreement Procedure) that allow taxpayers to bring to the attention of the competent authorities problems under the treaty and that authorize the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the treaty. Under these provisions, collectively referred to as the mutual agreement procedure ("MAP"), a case that the competent authorities are unable to resolve may be submitted to arbitration if the competent authorities and the affected taxpayer agree to arbitration. The proposed protocol replaces this optional arbitration provision with rules for mandatory and binding arbitration for certain cases about which the competent authorities cannot

reach a negotiated agreement. The Memorandum of Understanding ("MOU") accompanying the proposed protocol provides additional rules and procedures governing the mandatory and binding arbitration. A mandatory and binding arbitration procedure is not included in the U.S. Model treaty, but has recently been included in the U.S. income tax treaties with Belgium, Canada, and Germany.

In general, the proposed protocol provides that a case will be resolved through arbitration if under the MAP the competent authorities have tried but are unable to reach a complete agreement in a case and if three additional conditions are satisfied.

First, tax returns must have been filed with at least one of the treaty countries for the taxable years at issue in the case. Second, the case must not be one that the competent authorities agree, before the date on which arbitration proceedings otherwise would have begun, is not suitable for determination by arbitration. Third, all concerned persons and their authorized representatives or agents must agree (in a "confidentiality agreement") before the arbitration proceedings not to disclose to any other person any information, other than the determination of the arbitration board, received during the course of the arbitration proceeding from either treaty country or the arbitration board. The Technical Explanation states that the confidentiality agreement may be executed by any concerned person that has legal authority to bind any other concerned person on the matter. For example, according to the Technical Explanation, a parent corporation with the legal authority to bind its subsidiary to keeping information confidential may execute a confidentiality agreement for itself and its subsidiary. The term "concerned person" means both the person that has presented a case to a competent authority for consideration under the MAP and all other persons whose tax liability to either treaty country may be directly affected by a mutual agreement arising from that consideration.

In no event, however, may an unresolved case be submitted to arbitration if a decision on the case has already been rendered by a court or administrative tribunal of either treaty country.

The MOU includes confidentiality rules for arbitration board members and staff and for the competent authorities. Those individuals may not disclose information relating to an arbitration proceeding (including the board's determination) unless disclosure is permitted by the treaty and the domestic laws of the United States and France. According to the MOU, all material prepared in the course of or relating to an arbitration proceeding is considered information exchanged between treaty countries. All members of the arbitration board and their staffs must send to each country statements in which they agree to abide by and be subject to the confidentiality and nondisclosure requirements of the treaty's exchange of information article and the applicable domestic laws of each country. If any of those provisions conflict, the most restrictive provision applies.

The MOU provides that an arbitration board's determination is limited to a conclusion about the amount of income, expense, or tax reportable to the treaty countries.

Under the MOU, even after an arbitration proceeding has been initiated, the competent authorities may agree to resolve a case and terminate the proceeding, and a concerned person may withdraw a request that the competent authorities engage in the MAP (and thereby terminate an arbitration proceeding) at any time.

The proposed protocol provides that arbitration proceedings in a case begin on the later of (1) two years after the commencement date of that case, unless both competent authorities previously have agreed to a different date, or (2) the earliest date on which both competent authorities have received from all concerned persons the confidentiality agreements described above. The commencement date of a case is the earliest date on which both competent authorities have received the information necessary to undertake substantive consideration for a mutual agreement.

The MOU provides that each competent authority must confirm in writing to the other competent authority and to the concerned person or persons the date on which it received the information necessary to undertake substantive consideration for a mutual agreement. Such information is submitted to the competent authorities under relevant internal rules and procedures of each of the treaty countries. However, this information is not considered received until both competent authorities have received copies of all materials submitted to either treaty country by the concerned person or persons in connection with the MAP.

Under the MOU, each treaty country has 90 days from the date on which an arbitration proceeding begins to send a written communication to the other treaty country appointing one member of the arbitration board. The members of the arbitration board may not be employees of the tax administration of the treaty country that appoints them. Within 60 days of the date on which the second such communication is sent, the two members appointed by the treaty countries must appoint a third member, and that member will serve as chair of the board. If the members appointed by the treaty countries fail to agree to a third member, those members will be treated as dismissed and each treaty country must appoint a new member within 30 days of the dismissal of the original members. The competent authorities are directed to develop a nonexclusive list of individuals with familiarity in international tax matters who may serve as the chair of the board, but in no case may the chair be a citizen of either treaty country. The MOU provides that the arbitration board may adopt any procedures necessary for the conduct of its business so long as the procedures are not inconsistent with any other provisions of Article 26.

Under the MOU, each treaty country is permitted to submit within 60 days of the appointment of the chair of the arbitration board a proposed resolution of the case and a supporting position paper. The proposed resolution describes the proposed disposition of the specific amounts of income, expense, or taxation at issue in the case. The arbitration board is required to provide copies of each treaty country's proposed resolution and supporting position to the other treaty country on the date on which the board receives the latter of the submissions. If only one treaty country submits a proposed resolution to the board within the 60-day time period, that proposed resolution is deemed to be the board's determination, and the proceeding will be terminated. Each treaty country is permitted to submit a reply submission to the board within 120 days of the appointment of the board chair. The arbitration board may request additional information, but the treaty countries are not otherwise permitted to submit additional information. If the arbitration board asks a treaty country for additional information, the board must provide to the other treaty country a copy of its request and a copy of the response it receives and must do so on the days on which the request is made and the response is received. Except in relation to limited logistical matters, the treaty countries and the arbitration board may communicate only through written communications between the competent authorities and the chair of the board.

Within 90 days of the appointment of the chair of the arbitration board, the MOU provides that the presenter of the case to the competent authority of a treaty country may submit a position paper for consideration by the arbitration board. The arbitration board is required to provide copies of any such submission to both treaty countries on the date on which the board receives the latter of the treaty country's submissions. No prior U.S. income tax treaty that has contained a mandatory and binding arbitration procedure has included a similar opportunity for the presenter of the case to the competent authority to submit a position paper to the arbitration board.

The MOU provides that the arbitration board must deliver a determination in writing to the treaty countries within six months of the appointment of the chair. The board must adopt as its determination one of the proposed resolutions submitted by the treaty countries.

The proposed protocol provides that unless a concerned person does not accept the determination of an arbitration board, the determination constitutes a resolution by mutual agreement and will be binding on both treaty countries. The MOU provides that the determination may not state a rationale and has no precedential value. Under the MOU, each concerned person must, within 30 days of receiving the board's determination from the competent authority to which the case was first presented, advise that competent authority whether that concerned person accepts the determination. In the event the case is in litigation, any concerned person who is a party to the litigation must also advise, within the same time period, the relevant court of its acceptance of the determination of the arbitration board as the resolution by mutual agreement and withdraw from the consideration of the court the issues resolved through the arbitration. If a concerned person fails to advise the relevant competent authority, and any relevant court, within the 30-day period, the determination is considered not to have been accepted. Any case in which the determination of the arbitration board is not accepted may not later be a subject of arbitration.

The members of the arbitration board and their staffs are considered persons or authorities to whom information may be exchanged under Article 27 (Exchange of Information) of the present treaty.

The MOU provides several additional rules related to the operation of an arbitration proceeding. An arbitration board in a particular case will meet in facilities provided by the treaty country whose competent authority initiated the MAP in that case. The treatment of interest and penalties associated with an arbitration case is determined by applicable domestic law of the relevant treaty country or countries. In general, the fees of members of the arbitration board will be set at a fixed amount of $2,000 per day or the equivalent amount in euro, subject to modification by the competent authorities. In general, the expenses of members of the arbitration board are set in accordance with the International Centre for Settlement of Investment Disputes ("ICSID") Schedule of Fees for arbitrators, as in effect on the date on which the arbitration proceedings begin, subject to any modifications by the competent authorities. The arbitration board members' fees and expenses, as well as any fees for language translation, are borne equally by the United States and France. The treaty country whose competent authority initiated a MAP in a particular case is to provide, at its own cost, meeting facilities, related resources, financial management, other logistical support, and general administrative coordination of the proceeding. Any other costs are borne by the treaty country that incurs them.

The competent authorities of the treaty countries may modify or supplement the rules and procedures provided in the MOU to the extent necessary to better implement the intent of mandatory arbitration to eliminate double taxation.

Article XI. Exchange of Information

The proposed protocol replaces Article 27 (Exchange of Information) of the present treaty. Most of the changes revise the article to conform more closely to Article 26 (Exchange of Information and Administrative Assistance) of the U.S. Model treaty. In doing so, the proposed protocol makes additions, deletions, and revisions to the text of Article 27 of the present treaty.

The proposed protocol provides that the competent authorities will exchange such information as is relevant to carry out the provisions of the treaty or the administration or enforcement of the domestic tax laws of the treaty country. The scope of the information that may be exchanged is not restricted by either Article 1 (Personal Scope) or Article 2 (Taxes Covered) and extends to all taxes imposed at the national level, in contrast to the present treaty, which limits exchange of information to information related to taxes identified in. Therefore, information with respect to third-country residents is covered by the proposed protocol, as is information about any tax imposed at the national level. According to the Technical Explanation, these taxes include U.S. estate and gift taxes, excise taxes and, with respect to France, value added taxes. In using the term "relevant" rather than "necessary" to establish the standard for determining whether or not information may be exchanged under the treaty, the protocol conforms to the standard used in Code section 7602, which is the principal source of authority for United States information gathering and examination of records. Under section 7602, the IRS may request to examine any books, records or other material that "may be relevant," as confirmed by the U.S. Supreme Court in a line of cases beginning with *United States v. Powell*.[92]

This protocol explains the duty to maintain confidentiality of the information subject to exchanges and is similar to the confidentiality provisions in paragraph 1 of the present treaty. The secrecy provision in the proposed protocol is also consistent with the U. S. Model treaty and requires that any information exchanged under the proposed protocol is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts, administrative bodies and legislative bodies) involved in the administration, enforcement or oversight of the tax laws. Such functions include assessment, collection, civil and criminal prosecution, and the determination of appeals in relation to the taxes within the scope of Article 27. The authority to disclose information to persons involved in oversight of taxes includes authority to disclose to persons or authorities such as the tax-writing committees of Congress and the Government Accountability Office. Such persons or authorities receiving the information may use the information only in the performance of their role in overseeing the administration of U.S. tax laws. Finally, exchanged information may be disclosed in public court proceedings or in judicial decisions.

[92] 379 U.S. 48 (1964).

As is true under the U.S. and OECD Model treaties, under the proposed protocol, a treaty country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process or information, the disclosure of which would be contrary to public policy.

The proposed protocol provides several limitations on the scope of the foregoing restrictions on the obligation of a requested treaty country to exchange information. Under paragraph 4(a) of the proposed article, a country receiving a request in accordance with this article must attempt to obtain the requested information in the same manner and to the same extent as if the tax of the requesting country were the tax of the other treaty country and were being imposed by that country, notwithstanding that such other country does not have a domestic interest in the information. Thus, the fact that a statute of limitations in the requested treaty country would bar use of the information in a domestic tax examination will not relieve that treaty country of obtaining and exchanging the information with the treaty partner.

Paragraph 4(b) of Article 27 conforms to paragraph 6 of Article 26 of the U.S. Model treaty, and requires that a country accommodate special requests about the form of information to be exchanged. Under this provision, if specifically requested by the competent authority of a country, the competent authority of the other country must provide information under this article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested country with respect to its own taxes.

Paragraph 4(c) of Article 27 permits each treaty country to send representatives to the sovereign territory of the other treaty country to conduct interviews with taxpayers and examine their books and records, if the taxpayers and the competent authority in that country consent, and only if the two countries have in place an exchange of diplomatic notes that provide a reciprocal basis for such inquiries. Although the Technical Explanation states that this paragraph corresponds to U.S. Model treaty, it is narrower in scope than the mandate of paragraph 8 of Article 26 of the U.S. Model treaty, which would extent to cooperative third party witnesses. The Technical Explanation explains that the provision is not intended to limit any procedures that have previously been agreed upon by the competent authorities of the respective treaty countries.

Under the proposed protocol, a new paragraph similar to paragraph 5 of Article 26 of the U.S. Model treaty limits the ability of either country to posit that domestic secrecy laws preclude response to a request for information. The proposed protocol explicitly states that notwithstanding the general principle that the treaty does not require a treaty country to act at variance with its domestic law, a treaty country cannot refuse to provide information simply because the information to be obtained is maintained by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. This provision thus explicitly overrides bank secrecy rules of the requested jurisdiction. With regard to persons acting in an agency or fiduciary capacity, the scope of any override of domestic law is not explained in the Technical Explanation.

The proposed protocol also provides that the competent authorities may not refuse to exchange information because it relates to information concerning ownership interests in a "person." Because this language refers to person and not "instruments", it may not require that a competent authority obtain and exchange information needed to identify the beneficial owner of a bearer bond. The Technical Explanation confirms that the provision does require the disclosure of information regarding the beneficial owner of an interest in a person.

Article XII. Assistance in Collection

The proposed protocol amends Article 28 (Assistance in Collection) of the present treaty, which deals with assistance in collection, by replacing paragraph 5, which identifies the persons whose tax debts may be the subject of such assistance. The protocol deletes an obsolete reference to paragraph 4 of Article 10 (Dividends).

The assistance in collection articles of income tax treaties generally provide rules governing the treaty countries' assistance of one another in collecting taxes. In general, under the present treaty, the United States and France agree to assist each other in the collection of all taxes, to which the treaty applies, together with interest, costs, additions to taxes, and civil penalties. Paragraph 5 of Article 28 does not require that either treaty country provide assistance for a revenue claim in respect of its own citizens or of entities formed within the country whose assistance is sought, with one exception.

The exception in paragraph 5 permits assistance in recovering a tax debt resulting from a determination by the competent authorities that a person improperly received a payment from France under paragraph 4 of Article 10. Paragraph 4 of Article 10 requires that France pay a United States resident in receipt of dividends from a French company an amount equal to the tax credit (*avoir fiscal*) to which a French resident in receipt of those dividends would be entitled. Because the *avoir fiscal* has been repealed, the cross-reference in Article 28 to Article 10 is now obsolete.

Article XIII. Miscellaneous Provisions

Saving clause

Like all U.S. income tax treaties and the U.S. Model treaty, the present treaty includes a saving clause, which is set forth in Article 29 (Miscellaneous Provisions). Under this clause, with specific exceptions, the treaty does not affect the taxation by the United States of its residents and citizens. Thus, the United States generally may continue to tax its residents and citizens who are residents of France as if the treaty were not in force. For purposes of the proposed protocol (and, thus, for purposes of the saving clause), the term "residents," which is defined in Article 4 (Residence), includes corporations and other entities as well as individuals.

The proposed protocol modifies the saving clause to reflect changes in U.S. tax law relating to the present treaty provision under which a former U.S. citizen or long-term resident may be taxed under U.S. law for the period of ten years following the loss of such status, provided that the loss of such status had as one of its principal purposes the avoidance of tax. Under the proposed protocol, a former citizen or former long-term resident of either treaty country may, for the period of ten years following the loss of such status, be taxed in accordance

with the laws of that treaty country. Under the proposed protocol, the provision no longer includes the requirement of a purpose to avoid tax.

Under U.S. domestic law, an individual is considered a "long-term resident" of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. However, an individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Like U.S. domestic law, the proposed protocol defines a "long term resident" as, with respect to either treaty country, any individual (other than a citizen of that treaty country) who is a lawful permanent resident of that treaty country in at least eight taxable years during the preceding 15 taxable years.

Section 877 of the Code provides special rules for the imposition of tax on certain individuals who expatriate (that is, U.S. citizens and long-term residents who relinquish their citizenship or cease to be long-term residents) before June 17, 2008. Under Code section 877, those taxpayers are subject to U.S. tax for a period of ten years on both their U.S.-source income (including deemed U.S.-source income) and foreign-source income that is effectively connected with the conduct of a trade or business within the United States.

For any individual who expatriates on or after June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008,[93] replaces Code section 877 with the mark-to-market regime provided in Code section 877A. In general, taxpayers who expatriate are treated as having sold all of their property on the day before the expatriation date for its fair market value.[94] However, at a taxpayer's election, the time for payment of additional tax attributable to any gain so recognized (but not realized) may be deferred until the taxpayer actually disposes of property deemed sold.[95] This election may be made only if the taxpayer irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.[96]

The proposed protocol's ten-year grant of taxing jurisdiction to the treaty country from which an individual has expatriated corresponds with the ten-year rule in Code section 877. However, for any individual who expatriates on or after June 17, 2008, Code section 877A requires the payment of tax after the ten-year period if that individual elects to defer payment of the Code section 877A tax and sells property after the ten-year period. In this circumstance, the

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[93] Pub. L. No. 110-245, sec. 301 (June 17, 2008).

[94] Code sec. 877A(a)(1).

[95] Code sec. 877A(b)(1).

[96] Code sec. 877A(b)(5).

individual will have been required, as a condition of making the election under Code section 877A, to waive the benefits of the proposed protocol's ten-year rule.

The proposed protocol also provides that France may tax entities that have their place of effective management in France and that are subject to tax in France as if paragraph 3 of Article 4 (Residence) of the treaty had not come into effect.

Green-card holders

The proposed protocol overrides the rules of Article 19 (Public Remuneration) in certain cases. Under the present treaty, remuneration, other than a pension, paid by France, a local authority thereof, or an agency or instrumentality of France or a local authority thereof, to a lawful permanent resident of the United States, whether or not a national of France, for services provided to the French government in the United States is taxable in both France and the United States. Double taxation is relieved under paragraph 1 of Article 24 (Relief from Double Taxation).[97] This treatment may result in double taxation if the limitations of the law of the United States disallow credit for some of the French tax. The proposed protocol remedies this problem by providing that remuneration paid by the French government to green-card holders working for the French government in the United States is taxable only in the United States. The proposed protocol also provides that remuneration paid by the French government to nationals and residents of the United States for services provided to the French government in the United States is taxable only in the United States even if the service provider is also a national of France. Under the present treaty, such remuneration is exempt from U.S. tax if the service provider is a national of both countries.

Conforming changes

The proposed protocol changes paragraph 3(b) of Article 29 to make the exception to paragraph 2 of Article 29 bilateral, consistent with the bilateral application of the rules for former citizens and former long-term residents. It also updates cross-references in paragraph 7(b) to conform to the change in paragraph numbering in Article 24 (Relief from Double Taxation).

[97] See also Announcement 97-61, 1997-29 I.R.B. 13 (extending the resourcing rule of Article 24(1)(c) to green card holders).

Article XIV. Limitation on Benefits

In general

The proposed protocol replaces the rules of Article 30 (Limitation on Benefits) of the present treaty with rules that are similar to the limitation-on-benefits provisions included in recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in France or the United States.

The present treaty, as modified by the proposed protocol, serves to limit double taxation caused by the interaction of the tax systems of the United States and France as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to all the benefits accorded by the proposed protocol if the resident has any one of seven listed attributes. The seven attributes are that the resident is: (1) an individual; (2) one of the two treaty countries, a political subdivision (in the case of the United States) or local authority of one of the two countries, or an agency or instrumentality of a treaty country, political subdivision, or local authority; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) a pension trust or other similar organization that satisfies a beneficiaries test or is sponsored by an organization that meets the limitation-on-benefits requirements; (5) a not-for-profit organization established and maintained in its country of residence, provided that domestic law limits the use of the organization's assets to the accomplishment of the purpose that serves as the basis for the organization's exemption from income tax; (6) an entity that satisfies an ownership test and a base erosion test; or (7) an investment entity that satisfies an ownership test. A resident that has none of these seven attributes may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

Special anti-abuse rules govern items of income derived from one of the treaty countries by an enterprise resident in the other treaty country in so-called "triangular cases."

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Seven attributes for qualification for all treaty benefits

Individuals

Under the proposed protocol, an individual resident of the United States or France is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed protocol provides that the United States and France, any political subdivision (in the case of the United States) or local authority of either of the two countries, and any agency, instrumentality of a treaty country, political subdivision, or local authority are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of the United States or France is entitled to all treaty benefits if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence (or, in the case of a company resident in France, on a recognized stock exchange located within the EU or, in the case of the United States, on a recognized stock exchange located in another country that is a party to the North American Free Trade Agreement) (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

The term "shares" includes depository receipts for shares.

A company that is resident in one treaty country has a "disproportionate class of shares" if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, a company resident in France meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The term "regularly traded" is not defined in the present treaty or in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(4)(i)(B). Based on that provision, the Technical Explanation states that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation notes that trading on one or more recognized stock exchanges may be aggregated for purposes of meeting the "regularly traded" requirement.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the French stock exchanges controlled by the "Autorité des marchés financiers"; the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Lisbon, Madrid, Milan, Stockholm, Sydney, Tokyo, Toronto, and the Swiss stock exchange; and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term "primarily traded" is not defined in the present treaty or in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded in the company's country of residence if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares (and any disproportionate class of shares) of which is regularly traded on a recognized stock exchange, but which does not satisfy the primary trading test (that is, the requirement that a company's principal class of shares be primarily traded on a recognized stock exchange in the company's country of residence), may claim treaty benefits if it satisfies the management and control test – that is, if the company's primary place of management and control is in the treaty country of which it is a resident. A company's primary place of management and control is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if the staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test often has been interpreted to mean the place where the board of directors meets. Under the proposed

protocol, by contrast, the management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the United States or France. This rule allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the treaty.

Pension trusts and other similar organizations

A pension trust and any other organization established in the organization's country of residence and maintained exclusively to administer or provide retirement or employee benefits that is established or sponsored by a person that is a resident of the same treaty country is entitled to all the benefits of the proposed protocol if more than 50 percent of the organization's beneficiaries, members, or participants are individuals resident in either the United States or France. However, the beneficiaries test need not be satisfied if the organization is sponsored by an organization that meets the limitation-on-benefits requirements of this article. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization.

Not-for-profit organizations

Any not-for-profit organization established and maintained in its country of residence is entitled to treaty benefits, provided that the laws of such treaty country or (in the case of the United States) a political subdivision of such treaty country limit the use of the organization's assets, both currently and upon the dissolution or liquidation of such organization, to the accomplishment of the purposes that serve as the basis for such organization's exemption from income tax. The Technical Explanation notes that a not-for-profit organization other than a pension trust qualifies for benefits without regard to the residence of its beneficiaries or members.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year shares or other beneficial interests representing at least 50 percent of the entity's aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension trusts, or not-for-profit organizations. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension trusts, or not-for-profit organizations. Arm's-length payments made in the ordinary course of business for services or tangible property, and certain payments in respect of financial obligations to a bank that is not related to the payer, do not count against the entity in determining whether the 50-percent threshold is reached.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the ownership and base erosion tests.

Investment entities

An investment entity referred to in paragraph 2(b)(iii) of Article 4 (Resident), as amended by the proposed protocol, is entitled to treaty benefits if it satisfies an ownership test.[98] The ownership test requires that more than 50 percent of the shares, rights, or interests in the entity be owned, directly or indirectly, by residents of that same treaty country who are entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension trusts, or not-for-profit organizations. In the case of an investment entity resident in the United States, citizens of the United States may also count towards satisfaction of the ownership test. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test.

Derivative benefits rule

The proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty-country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement.

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries.

[98] The investment entities referred to in paragraph 2(b)(iii) of Article 4 are, in the case of the United States, a RIC, REIT, or REMIC, and in the case of France, a SICAV, SIIC, or SPPICAV. Any similar investment entities agreed upon by the competent authorities of both treaty countries are also included.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not equivalent beneficiaries is less than 50 percent of the company's gross income for the year, as determined in the company's country of residence. Arm's-length payments made in the ordinary course of business for services or tangible property, and certain payments in respect of financial obligations to a bank that is not related to the payer, do not count against the entity in determining whether the 50-percent threshold is reached.

An equivalent beneficiary must be a resident of an EU member state or of a party to the North American Free Trade Agreement (together, "qualifying countries") and must satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the proposed protocol are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed protocol's rules, described above, for individuals, governments, parent companies that meet the public company test, pension trusts, and not-for-profit organizations. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would meet the proposed protocol's requirements for entitlement to treaty benefits as an individual, a government, a parent company that meets the public company test, a pension trust, or a not-for-profit organization. Second, for insurance premiums and income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to an exemption from excise tax on such premiums or a rate of tax on that income that is at least as low as the rate applicable under the present treaty, as amended by the proposed protocol (the "tax rate test").

The Technical Explanation gives the following example to illustrate the operation of the tax rate test. A U.S. company is wholly owned by a French company that in turn is wholly owned by an Italian company. Assume the French company otherwise satisfies the requirements of the five-percent rate dividend provision, and assume that if the Italian company received a dividend directly from the U.S. company, the applicable dividend withholding tax rate under the U.S.-Italian treaty would be five percent. Under these facts, the Italian company would be a resident of a qualifying country under the rules described above because it would be entitled to a withholding tax rate at least as low as the applicable rate (five percent) under the present treaty, as amended by the proposed protocol.

The proposed protocol provides a special rule to take into account the fact that withholding taxes on many intercompany dividends, interest, and royalties are exempt within the EU by reason of various EU directives, rather than by tax treaty. If a U.S. company receives such payments from a French company, and that U.S. company is owned by a company resident in an EU member state that would have qualified for an exemption from French withholding tax pursuant to any directive of the EU if it had received the income directly, the EU parent company will be treated as an equivalent beneficiary. The Technical Explanation notes that this rule is necessary because many EU member countries have not renegotiated their tax treaties to reflect the rates applicable under the directives.

A person satisfies the second criterion of the ownership requirement if the person is a U.S. or French resident entitled to treaty benefits under one of the rules described previously for individuals, governments, parent companies that meet the public company test, pension trusts, or not-for-profit organizations. Under this rule, according to the Technical Explanation, a French individual qualifies with respect to an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion was included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or French company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a French company is owned by five companies that are residents of EU member states and that satisfy the first criterion described previously (the applicable treaty rules and the tax rate test), and 10 percent of the French company is owned by a U.S. or a French individual, the French company still can satisfy the requirements of the ownership test of the derivative benefits rules.

Active business test

Under the proposed protocol, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, and (2) the income from the other country is derived in connection with or is incidental to that trade or business. The proposed protocol provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer.

The term "trade or business" is not defined in the present treaty or in the proposed protocol. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the treaty, when determining whether a resident of France is entitled to the benefits of the treaty under the active business test with respect to an item of income derived from sources within the United States, the United States ascribes to this term the meaning that it has under the laws of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority is to refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, a trade or business is considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally is considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally is considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity tends to result in success or failure for the other. In cases in which more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation is considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed protocol provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country.

The proposed protocol provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons

"connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The triangular case

The proposed protocol provides a special anti-abuse rule that, according to the Technical Explanation, addresses a French resident's use of the following structure to earn interest income from the United States. The French resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The French resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the French resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between France and the third country, France does not tax the income earned by the permanent establishment. Alternatively, France may choose to exempt the income of the permanent establishment from French income tax. Consequently, the income is not taxed in France or the United States, and is only lightly taxed in the third country.

Under the proposed protocol, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in France and the third country is less than 60 percent of the tax that would have been payable to France if the income were earned in France and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision applies to all types of income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies is subject to tax under the domestic law of the source state, notwithstanding any other provision of the treaty.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, the triangular provision does not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or holding investments for the person's own account, unless the business is banking or securities activities carried on by a bank or a registered securities dealer).

The triangular provision applies reciprocally. However, the United States does not exempt the income of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Grant of treaty benefits by the competent authority

Under the proposed protocol, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted. The competent authority of the source country is required to consult with the competent authority of the residence country before denying treaty benefits under this provision.

Article XV. Provisions for Implementation

The proposed protocol deletes and replaces paragraph 1 of Article 32 of the present treaty. The change revises paragraph 1 so as to remove obsolete cross-references to provisions of paragraph 4(i) of Article 10 (Dividends) and paragraph 8 of Article 30 (Limitation on Benefits) of the present treaty.

Article XVI. Entry into Force

The proposed protocol is subject to ratification in accordance with the applicable procedures of each treaty country. Each treaty country is to notify the other in writing, through diplomatic channels, when it has completed the required procedures. The proposed protocol will enter into force on the date of receipt of the later of the notifications.

With respect to withholding taxes (principally dividends and royalties), the proposed protocol has effect for amounts paid or credited on or after the first day of the January of the year in which the proposed protocol enters into force. For example, where, as a result of the second notification being received on April 25 of a given year, the treaty rate of withholding under paragraph 2 of Article 10 (Dividends), as amended by the proposed protocol, would be applicable to dividends paid on or after January 1 of that year. As a result, the benefits of the withholding rate reduction will be in effect for the entire year for which the proposed protocol enters into force. To the extent a withholding agent withholds at a higher rate on payments made during the year the proposed protocol enters into force but prior to the date the proposed protocol enters into force (for example, payments prior to April 25 in the above example), a beneficial owner of the income that is a resident of France may make a claim for refund pursuant to section 1464 of the Code.

For other taxes, the proposed protocol has effect for taxes imposed for tax periods beginning on or after the first day of January next following the date on which the proposed

protocol enters into force. By way of example, for taxes on capital, the Technical Explanation clarifies that the proposed protocol has effect for taxes levied on items of capital owned on or after January 1 next following the date the proposed protocol enters into force.

The proposed protocol provides an exception to the above general rules with respect to the mandatory and binding arbitration provisions of Article X (Mutual Agreement Procedure) of the proposed protocol. It states that Article X of the proposed protocol is effective both for (1) cases that are under consideration by the competent authorities as of the date on which the proposed protocol enters into force, and (2) cases that come under such consideration after that time. It further provides that, for any cases that are already under consideration by the competent authorities as of the date on which the proposed protocol enters into force, the commencement date is deemed to be the date the proposed protocol enters into force. Therefore, in applying these rules to paragraph 6(c) of Article 26 (Mutual Agreement Procedure), as amended by the proposed protocol, unresolved cases as of the date that the proposed protocol enters into force go into binding arbitration on the later of (1) two years after the entry into force of the proposed protocol unless both competent authorities have agreed to an earlier date, and (2) the earliest date upon which the agreement required by paragraph 6(d) of Article 26 (Mutual Agreement Procedure), as amended by the proposed protocol, has been received by both competent authorities. For example, if the second notification is received on April 25, 2010, any open cases as of that date will go to binding arbitration on April 25, 2012, absent an agreement by the competent authorities of the United States and France to an earlier date and provided that the agreement required by paragraph 6(d) of Article 26 (Mutual Agreement Procedure) has been received by both competent authorities before April 25, 2012.

VI. ISSUES

A. Arbitration

Background

Like other U.S. income tax treaties, the present treaty includes a mutual agreement procedure. The mutual agreement procedure allows taxpayers to bring to the attention of the competent authorities problems under the treaty, and it authorizes the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the treaty. Under the present treaty, a case that the competent authorities are unable to resolve may be submitted to voluntary arbitration if the competent authorities and the affected taxpayer agree to arbitration. Article X of the proposed protocol replaces this optional arbitration provision with rules for mandatory and binding arbitration of certain cases about which the competent authorities cannot reach a negotiated agreement. The rules governing the process and substance of the arbitration are described in detail above in Part V.

Tax treaties traditionally have not included a mechanism to ensure resolution of disputes, and the voluntary binding arbitration procedures described above have never been invoked in any U.S. mutual agreement procedure. Moreover, in the case of the United States, the average processing time on closed competent authority cases may approach or exceed two years,[99] and some observers believe that a significant number of cases simply are never resolved. As a consequence, many commentators as well as participants in the competent authority process have expressed the view that the traditional mutual agreement procedure often does not fulfill its stated objective of providing relief from double taxation. Proponents of mandatory arbitration believe that incorporating into the mutual agreement process a mechanism that would ensure the resolution of disputes would address this problem, for two reasons. First, disputes that could not be resolved by the competent authorities within a prescribed time frame would be finally and completely resolved through the arbitration process. More fundamentally, however, proponents argue that the existence of a mandatory arbitration process will impel the competent authorities to reach mutual agreement, so as to avoid any arbitration proceedings. This argument is premised on the belief that the competent authorities would prefer to negotiate their own settlement to having an outcome imposed by an arbitration board. Proponents further believe that, if a competent authority is concerned that an arbitration board may determine the matter adversely to that competent authority, mutual agreement on reasonable and moderate grounds will be more likely. These proponents hold the view, therefore, that while few, if any, actual arbitrations will occur, many more cases will be resolved promptly and appropriately through the mutual agreement procedure. On the other hand, some commentators have argued that there is no evidence to date that the existence of mandatory arbitration changes the negotiating posture of the competent authorities.

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[99] See Internal Revenue Service, Deputy Commissioner (International), Large and Mid-Size Business Division, "Competent Authority Statistics," which has been prepared and presented annually by the IRS at the Annual Institute on Current Issues in International Taxation.

If the proposed protocol enters into force, the U.S.-France treaty will be the fourth bilateral U.S. income tax treaty to provide mandatory and binding arbitration of unresolved cases. Similar arbitration provisions are found in the U.S.-Belgium treaty, which entered into force at the end of 2007, the protocol to the U.S.-Germany treaty, which entered into force at the end of 2007, and the protocol to the U.S.-Canada treaty, which entered into force at the end of 2008. The staff of the Joint Committee on Taxation has provided detailed analyses of those arbitration provisions,[100] including the "last best offer" or "final offer" arbitration methodology adopted in the treaty with Belgium and the protocols with Germany and Canada.[101] Those analyses also include descriptions of mandatory arbitration procedures adopted in the OECD Model treaty and by the European Union. The following is a more limited discussion of certain key features of the arbitration provision of the proposed protocol that differ in some way from one or more of the analogous provisions in the treaties with Belgium, Germany, and Canada.

The discussion below concerns particular features of the arbitration provision of the proposed protocol. More generally, the Committee may wish to ask about the Treasury Department's intentions for future U.S. income tax treaties and protocols (particularly given the absence of a mandatory arbitration provision in the proposed treaty with Malta and the proposed protocol with New Zealand). Does the Treasury Department expect that mandatory arbitration provisions following the framework of the provision in the proposed protocol and in the treaties with Belgium, Germany, and Canada will become a standard feature of future U.S. tax treaties, or will the Treasury Department be more selective in choosing the countries with which it negotiates such provisions? If the Treasury Department expects mandatory arbitration to become a standard feature in future U.S. tax treaties, will the Treasury Department revise the U.S. Model treaty to include mandatory arbitration rules? If mandatory arbitration is not expected to be a part of all future U.S. income tax treaties, it may be useful to ask what criteria the Treasury Department will use to determine whether a particular treaty should include mandatory and binding arbitration.

Scope

In general, a case may be resolved through arbitration under the proposed protocol and the accompanying MOU in any case involving the application of any article of the treaty (so long as the competent authorities have not agreed that the particular case is not suitable for arbitration). In this respect, the proposed protocol is the same as the U.S.-Belgium treaty.

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[100] See Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Belgium* (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada* (JCX-57-08), July 8, 2008.

[101] In "last best offer" or "final offer" arbitration, each of the parties proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. The methodology is intended to encourage the competent authorities not to assert unreasonable claims. In the United States, this arbitration methodology is also informally known as "baseball arbitration" because it is similar to the procedure used to resolve Major League Baseball salary disputes.

In contrast, the protocols to the U.S.-German treaty and U.S.-Canada treaty each provide that a case may be resolved through the mandatory arbitration procedure only if it involves the application of one or more of the following articles of the treaty (and is not a particular case that the competent authorities agree is not suitable for determination by arbitration): Article 4 (Residence), but only to the extent the case relates to the residence of natural persons; Article 5 (Permanent Establishment); Article 7 (Business Profits); Article 9 (Related Persons), and Article 12 (Royalties), but only to the extent the case relates (1) to the application of Article 12 to transactions involving related persons or (2) to an allocation of amounts between taxable and nontaxable royalties.

The Committee may wish to consider the proper scope of mandatory arbitration in the proposed protocol. In particular, the Committee may wish to consider whether mandatory arbitration should be available for all articles under a treaty or only for articles that have given rise to cases that historically have been difficult to resolve under the mutual agreement procedure. In addition, the Committee may wish to inquire as to the Treasury Department's preferred approach and the circumstances in which the Treasury Department is willing to deviate from that approach.

The Committee also may wish to consider the basis for the rule included in the proposed protocol and in the treaties with Belgium, Germany, and Canada permitting the competent authorities to agree that a particular case is not suitable for arbitration. It is unclear what factors the competent authorities will take into account in deciding that a particular case is or is not suitable for arbitration. Granting broad discretion to the competent authorities in making such a decision may help facilitate agreements in individual cases, but it also is possible that a lack of explicit factors for deciding which cases may go to arbitration could create unpredictability for taxpayers and undermine the efficacy of the mandatory arbitration procedure.

Absence of reasoned opinion and precedential value

Like the treaties with Belgium, Germany, and Canada, the proposed protocol provides that the arbitration board will limit its determination to stating an amount of income, expense, or tax reportable to the treaty countries. In addition, under the proposed protocol, the determination will not state a rationale and will have no precedential value. Arbitration board determinations under the treaties with Belgium, Germany, and Canada also will not include rationales and will have no precedential value. By contrast with the proposed protocol and the treaties with Belgium and Canada, however, the treaty with Germany includes (in the diplomatic notes) a statement that although decisions of the arbitration board do not have precedential effect, it is expected that decisions ordinarily will be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue, and substantially similar facts, and may also be taken into account in other cases in which appropriate.

The requirement that the arbitration board not provide a rationale appears to follow from the "last best offer" structure of the arbitration process.[102] The arbitration board must choose one

[102] The advantages and disadvantages of the "last best offer" approach are discussed generally in Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and*

of the two proposals submitted to it by the competent authorities without modification. As a result, the arbitration board's decision does not necessarily represent the independent view of the board as to the "right" answer, but rather its decision as to which of the two offers is the least wrong. It has been suggested that a reasoned decision in these circumstances would be less helpful than it might be in a case in which the arbitration board is permitted or required to reach its own conclusion as to how to resolve a matter. The Committee may wish to inquire, however, into the possible significance of the proposed protocol's omission of any statement that arbitration board decisions should be taken into account in certain similar subsequent cases. Does the omission of such a statement mean that, unlike under the treaty with Germany, under the proposed protocol an arbitration board decision will have no consequence at all for future determinations?

Taxpayer participation

The MOU accompanying the proposed protocol provides that the presenter of a case to the competent authority of a treaty country may submit a position paper to the arbitration board for consideration. Such an opportunity does not exist under the treaties with Belgium, Germany, or Canada, which provide that position papers and proposed resolutions may be submitted only by the two treaty countries. The Committee may wish to consider the nature of this opportunity under the proposed protocol. In particular, it may wish to inquire as to the types of issues that are expected to be addressed in the position paper of the presenter of the case and the manner in which the treaty countries and the arbitration board are expected to utilize any such submission.

In addition, the Committee may wish to consider whether the presenter of the case should have the opportunity to present to the arbitration board a proposed resolution in addition to a position paper. Ultimately, the proposed protocol requires the arbitration board to adopt as its determination one of the proposed resolutions submitted by the treaty countries, and does not permit the arbitration board to provide a rationale for its determination. Under these conditions, the Committee may question the utility of permitting a presenter of a case to submit only a position paper. The Committee may also wish to consider the potential consequences of permitting a third proposed resolution to be submitted to the arbitration board. For example, how would such a possibility affect the proposed resolutions submitted by the treaty countries and the decision of the arbitration board?

The U.S. Model treaty (which does not include a mandatory arbitration provision) does not provide the presenter of a case an explicit opportunity to participate in a case that is being resolved under the standard MAP. Instead, the U.S. Model treaty provides that a taxpayer may present its case to the competent authority, which then endeavors to resolve the case with the competent authority of the other treaty country. The Committee may wish to inquire as to how the opportunity for the presenter of the case to explicitly participate under the mandatory arbitration procedure differs from the way that the presenter of a case participates in a case under the standard MAP. In particular, the Committee may wish to inquire as to how, if at all, the

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Belgium (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007.

presenter of a case participates in the resolution of that case with the other competent authority under the standard MAP. In addition, the Committee may wish to consider whether U.S. tax treaties should explicitly provide such an opportunity for the presenter of the case.

Required Treasury report on mandatory arbitration

As a condition of ratifying the protocol with Canada last year, the Senate included a reporting requirement with respect to the mandatory and binding arbitration provision. Specifically, the condition requires a two-part report. First, within two years after the protocol with Canada enters into force, and before the first arbitration conducted pursuant to the mandatory arbitration procedure, the Treasury Department must submit the text of the rules of procedure applicable to arbitration boards, including conflict of interest rules to be applied to members of the arbitration board, to the Senate Committees on Finance and Foreign Relations and the Joint Committee on Taxation.[103] Similarly, the Treasury Department must also submit to those Committees the same material with respect to the arbitration procedure in the Belgium treaty and the protocol with Germany before the first arbitration conducted pursuant to the mandatory arbitration procedure of each of those treaties.[104]

The second part of the report requires specific data on the arbitrations conducted pursuant to the Belgium, Germany, and Canada treaties. This portion of the report must be submitted by the Treasury Department to the Joint Committee on Taxation and the Senate Committee on Finance within 60 days after a determination is reached in the 10th arbitration proceeding conducted pursuant to either the Belgium, Germany, or Canada treaty. Information under this second part of the report must be submitted annually for five years following the first year in which it is submitted.

Information with respect to the arbitration provision of the proposed protocol, including any information of the type described above with respect to the Belgium, Germany, and Canada treaties is not required to be included in the Treasury Department report. The Committee may wish to consider whether it is appropriate to expand the scope of the required Treasury Report to include information with respect to the arbitration procedure of the proposed protocol.

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[103] Rules of procedure applicable to arbitration boards with respect to the arbitration procedure in the protocol with Canada have not been finalized and thus have not yet been submitted by the Treasury Department.

[104] The Treasury Department has made the text of the rules of procedure applicable to arbitration boards with respect to the arbitration procedure in the Belgium treaty and the protocol with Germany available on the IRS web site (http://www.irs.gov/businesses/international/article/0,,id=201209,00.html). See also Announcement 2009-43, 2009-24 I.R.B. 1075 (Memorandum of Understanding with Belgium regarding the arbitration procedure); Announcement 2009-44, 2009-24 I.R.B. 1079 (operating guidelines for arbitrations with Belgium); Announcement 2008-124, 2008-52 I.R.B. 1359 (Memorandum of Understanding with Germany regarding the arbitration procedure); Announcement 2008-125, 2008-52 I.R.B. 1363 (operating guidelines for arbitrations with Germany). However, the Treasury Department has not yet formally submitted these procedures to the Senate Committees on Finance and Foreign Relations and the Joint Committee on Taxation.

B. Exchange of Information

Background

Under Article XI of the proposed protocol, the present treaty Article 27 (Exchange of Information) is amended in several ways to conform more closely to the U.S. Model treaty. The proposed rules generally require the two competent authorities to exchange such information as may be relevant in carrying out the provisions of the domestic laws of the United States and France concerning taxes imposed at a national level, to the extent the taxation under those laws is not contrary to the treaty. The first double tax convention to which the United States was a party was entered into in 1932 with France. Although that first treaty did not contain an exchange of information provision, the treaty partners soon negotiated a second double tax convention, signed on July 25, 1939, that addressed mutual administrative assistance, including the exchange of fiscal information in certain circumstances and assistance in collection. Since then, the scope of exchange of information between the treaty partners has grown steadily and significantly. Given the long history of exchange of information between these treaty partners, one may infer that the exchange of information program as administered by the treaty partners has been satisfactory to both and is expected to continue.

Conditions under which entry into treaty country's sovereign territory is permitted

Paragraph 4(c) of the proposed protocol requires that a treaty country permit entry into its territory by representatives of the other treaty country in order to interview a taxpayer or examine the taxpayer's books and records, if the taxpayer has consented. The Technical Explanation states that this paragraph corresponds to the U.S. Model treaty, but does not elaborate on the extent to which they differ. The proposed protocol provides a significantly narrower scope of extraterritorial activity than is sanctioned by the U.S. Model treaty, in that the proposed protocol does not extend to consenting third parties. Under the U.S. Model treaty, a treaty country is required to permit entry to its territory for the purpose of conducting interviews and reviewing records with all persons who consent to such interviews or reviews. That provision would require permission to interview, and gather documents from, cooperative third-party witnesses, as well as the taxpayers. Finally, the proposed protocol retains the proviso of the present treaty that any inquiries that are conducted pursuant to the authority of this paragraph are not to be considered audits for purposes of French domestic law. There is no comparable limitation on whether an examination of books or records will be considered an audit under the Code. The lack of mutuality in this provision is not explained. The Committee may wish to inquire about the reasons for these deviations from the U.S. Model treaty as well as what effect they may have on taxpayers and enforcement of the U.S. tax laws.

Effectiveness of the U.S. Model treaty Article 26

Since the proposed protocol was signed last year, there has been extensive bilateral and multilateral cooperation in addressing issues of cross-border tax compliance and financial regulatory reform. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in the past year. Greater attention to all means of restoring integrity and stability to financial institutions has led to greater efforts to reconcile the conflicts between jurisdictions, particularly between jurisdictions with strict bank secrecy and

those seeking information to enforce their own tax laws.[105] As a result, the Committee may wish to inquire as to whether the U.S. Model treaty published in 2006 remains the appropriate standard by which to measure an effective exchange of information program.

The U.S. Model treaty conforms with the norms for transparency and effective exchange of information articulated by the OECD, which are in turn the standards by which the OECD determines whether a country is committed to transparency. Those standards require that the existence of mechanisms for exchange of information upon request; that exchange of information is available for purposes of domestic tax law in both criminal and civil matters; that there are no restrictions of information exchange caused by application of the dual criminality principle[106] or a domestic tax interest requirement; respect for safeguards and limitations; strict confidentiality rules for information exchanged; and availability of reliable information (in particular bank, ownership, identity and accounting information) and powers to obtain and provide such information in response to a specific request.[107]

Methods of exchange of information

The OECD standards do not require exchange other than upon specific requests for information, although the language would permit the treaty country to agree to provide for other exchange mechanisms. The OECD, in its commentary to the exchange of information provisions in the OECD Model treaty, specifies that the treaty "allows" the competent authorities to exchange information in any of three ways that treaty countries have traditionally operated[108] – routine, spontaneous,[109] or specific exchanges.[110] The present treaty at paragraph 3 of Article 26

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[105] See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009. Section VI of that pamphlet provides an overview of the international efforts to address these issues.

[106] The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.

[107] OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation*, p. 8.

[108] OECD, "Commentary on the Model Treaty Article 26," par. 9.

[109] A "spontaneous exchange of information" occurs when one treaty country is in possession of an item of information that it believes may interest the other treaty country for purposes of its tax administration and spontaneously transmits the information to that other country through their respective competent authorities.

[110] A "specific exchange" is a formal request by one contracting state for information that is relevant to an ongoing investigation of a particular tax matter. These cases are generally taxpayer specific. Those familiar with the case prepare a request that explains the background of the tax case and

specifies that the treaty partners will permit all three types of exchanges. That paragraph has been removed in the revised article, presumably as a redundant provision, no longer needed in light of the mutual understanding of the treaty countries as adherents to the OECD Model language.

With regard to specific exchanges of information, the Committee may wish to inquire as to the extent to which a request that a treaty country provide information in response to a John Doe summons[111] is a specific request within the meaning of the article, and whether protracted litigation similar to that which occurred in the UBS litigation[112] can be avoided or shortened.

The Committee may wish to explore issues related to "routine exchange of information." In this type of exchange, also referred to as "automatic exchange of information," the treaty countries identify categories of information that are consistently relevant to the tax administration of the receiving jurisdiction and agree to share such information on an ongoing basis, without the need for a specific request. Information that is automatically shared under this authority may include information that is not taxpayer-specific, such as news about changes in domestic tax legislation, or it may comprise voluminous taxpayer filings, such as magnetic disks containing the information from IRS Form 1042-S, relating to U.S.-source fixed or determinable income paid to persons claiming to be residents of the treaty country receiving the forms. The type of information, when it will be provided, and how frequently it will be provided are determined by the respective Competent Authorities after consultation. Once an agreement is reached, the information is automatically provided.

Practical challenges with automatic exchanges are not exclusive to the United States. The OECD has developed standards for the electronic format of such exchanges, to enhance their

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the need for the information and submit it to the Competent Authority in their country. If he determines that it is an appropriate use of the treaty authority, he forwards it to his counterpart.

[111] When the existence of a possibly noncompliant taxpayer is known but not his identity, as in the case of holders of offshore bank accounts or investors in particular abusive transactions, the IRS is able to issue a summons to learn the identity of the taxpayer, but must first meet greater statutory requirements, to guard against fishing expeditions. Prior to issuance of the summons intended to learn the identity of unnamed "John Does," the United States must seek judicial review in an *ex parte* proceeding. In its application and supporting documents,[111] the United States must establish that the information sought pertains to an ascertainable group of persons, that there is a reasonable basis to believe that taxes have been avoided, and that the information is not otherwise available.

[112] On July 1, 2008, a Federal district court in Florida granted the IRS permission to issue a John Doe summons to UBS seeking the names of as many as 20,000 U.S. citizens who were UBS customers for which reporting or withholding obligations may not have been met, Case No. 08-21864-MC-LENARD/GARBER. The summons was served on July 21, 2008. A petition to enforce that summons was filed on February 21, 2009. See *United States v. UBS AG*, Civil No. 09-20423 (S.D. Fla.). On August 19, 2009, after extensive negotiations between the Swiss and U.S. governments, the United States and UBS announced that UBS had agreed to provide information on over 4,000 U.S. persons with accounts at UBS.

utility to tax administration.[113] Despite these efforts to standardize the information exchanged and improve its usefulness, there remain numerous shortcomings, both practical and legal, in the routine exchange of information. Chief among them is the lack of taxpayer identification numbers ("TINs") in the information provided under the exchange, despite the recommendation of the OECD that member states provide such information.[114] Ideally, the information received by the IRS should either include a TIN or be subject to a process referred to as "TIN perfection" to enable the IRS to correlate account data in the information received with a valid TIN in its taxpayer databases, although such an undertaking may be time-consuming and costly.

The Committee may wish to inquire about the existence of any practical impediments to effective automatic exchange of information under the proposed treaty and what steps are needed to remove the impediments. In the past, there have been concerns that information received pursuant to automatic exchanges under bilateral and multilateral agreements was not in a usable form. Examples of practical hurdles that reportedly limited the value of information exchanged were the lack of timeliness of its production, lack of conformity in reporting periods, the need to translate the language of the documents and the currencies, and its voluminous nature.[115] To the extent that useful information can be gathered through exchange of information, the United States may be able to reduce its reliance upon self-reporting, that is, information provided by the taxpayer and therefore only available with respect to those in compliance with the tax laws.

U.S. reciprocity in providing information on beneficial ownership

The United States has come under increasing pressure to eliminate policies that provide foreign persons with the ability to shelter income. The criticism has focused on disparities between the U.S. standards and foreign standards governing "know-your-customer" rules for financial institutions and the maintenance of information on beneficial ownership. With respect to the latter, U.S. norms have been criticized in recent years.[116] The Committee may wish to explore the extent to which either the existing U.S. know-your-customer rules or the corporate formation and ownership standards prevent the United States from providing information about beneficial ownership on a reciprocal basis with its treaty countries. It may also consider whether

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[113] See OECD, Committee on Fiscal Affairs, *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes*, Module 3 (January 23, 2006) ("OECD Exchange Manual").

[114] The OECD Exchange Manual refers to a recommendation dating to 1997, "Recommendation on the use of Tax Identification Numbers in an International Context" C(97)29/FINAL (1997).

[115] Letter from Commissioner, IRS to Chairman, Senate Committee on Finance (June 12, 2006), 2006 *Tax Notes Today* 115-17.

[116] Financial Action Task Force, IMF, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism United States of America*, pp. 10-11 (June 23, 2006); Government Accountability Office, *Company Formations: Minimal Ownership Information Is Collected and Available,* a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate GAO-06-376 (April 2006); Government Accountability Office, *Suspicious Banking Activities: Possible Money Laundering by US Corporations Formed for Russian Entities*, GAO-01-120 (October 31, 2006).

there are steps to take that would help refute the perception that the United States permits states to operate as tax havens and help the United States better respond to information requests from foreign governments conducting their own tax evasion and anti-money laundering investigations of their citizens and residents suspected of engaging in illegal activities through U.S. corporations and limited liability companies.[117]

Override of domestic law privileges or confidentiality

The scope and operation of the provision that overrides potential arguments based on bank secrecy law of the requested treaty country presents questions about its possible impact on other privileges. Under the proposed article as well as both the OECD and U.S. Model treaties, a treaty country is generally not obligated to take any action at variance with its domestic law, including disclosure of professional or trade secrets. That principle is limited by a special rule, which provides that a treaty country may not decline to provide information on the ground that the information is held by a financial institution, nominee, or person acting in an agency or intermediary capacity. The Technical Explanations to the proposed protocol and to the U.S. Model treaty state that this rule overrides claims of bank secrecy, but do not address its potential intersection with the law of professional privileges. In contrast, the OECD explains the general principle and provides as an example of information that a requested treaty country could decline to obtain any information that would violate safeguards against self-incrimination.[118] The OECD further explains the abrogation of the general principle and clarifies that the provision may limit the use of certain claims of professional privilege, but only to the extent that the domestic law in question was so broad as to base its protection solely on the status of the person holding the information.[119] Under the OECD approach, a treaty country may refuse to supply information held by a bank, financial institution, agent, fiduciary or nominee as long as the ground for refusal is not the mere fact of the custodian's status as a bank, financial institution, agent, fiduciary or nominee. The OECD provides an example of a legal representative acting for a client in an agency capacity. To the extent that confidential communications between the legal representative and his client are protected under local law, the general rule against requiring a treaty country to violate its own law continues to apply and the treaty country may decline the request to exchange information.

At least one recently concluded treaty, the Income Tax Treaty between the United States and Finland,[120] departs from the U.S. Model treaty and expressly provides that the override of domestic law is not intended to include the ability to obtain information that would reveal confidential communications between a client and an attorney, in cases in which the client seeks

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[117] E.g., the "Incorporation Transparency and Law Enforcement Assistance Act," 111th Congress, 1st Sess., S. 569 (March 11, 2009), would require States to obtain and periodically update beneficial ownership information from persons who seek to form a corporation or limited liability company.

[118] OECD, "Commentary to the OECD Model Treaty Article 26," par. 15.2.

[119] OECD, "Commentary to the OECD Model Treaty Article 26," pars. 19.12, 19.14.

[120] Senate Treaty Doc. 109-18.

legal advice. The Committee may wish to inquire as to the intended scope of the provision of the proposed protocol and of the U.S. Model treaty, and the extent to which the provision may override any privilege or confidentiality law that may be available under a treaty country's domestic law, and the circumstances in which this provision is likely to be involved. The Committee may wish to specifically inquire about its effect on the attorney-client privilege in the United States.