Business Impact of the United States-France Income Tax Protocol[1]

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The 1978 Protocol to the France-United States Income Tax Treaty was signed as a result of both countries increasing the income taxes of United States citizens residing in France. This Article examines the operation of those provisions of the Protocol that impact on businesses and their employees. Specifically, this Article reviews provisions affecting partnerships, retired persons, investment income, certain fringe benefits, interest, business trips and shipping and aircraft. The author concludes that while the

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1. This article is dedicated to Maître Pierre Azard, whose influence on the author can only be described as profound. If the best teaching is by example, no better teacher will be found than Maître Azard.

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Protocol, when compared to the Treaty it modifies, does a good job of reducing double taxation, it does not do the best job.

INTRODUCTION

Since the end of World War II, United States citizens residing in France have enjoyed more favorable tax treatment than United States citizens residing in the United States. France taxed United States citizens in France (not domiciled in France) on French-source income, but not on foreign-source income.[3] Extraordinary deductions were accorded United States citizens against that income by French administrative fiat through the late 1960's.[4] The United States was equally considerate in granting favorable tax treatment. The first $25,000 of earned income of a foreign resident from sources outside the United States was excluded from the United States citizen's gross income[5] and the pain of French tax on French-source income was assuaged by the foreign tax credit.[6] Thus, the United States citizen living in Paris paid income tax to both France and the United States combined at a lesser rate on total income than did his colleague living in New York.

There is, however, a different way of viewing this matter. This view contrasts United States citizens residing in France to citizens of other countries residing in France with whom the United States citizens compete. Under this view, the best that could be said was that United States citizens were at a disadvantage vis-à-vis their non-French competitors. Those competitors paid no tax to France on their non-French income, and no tax to their country of nationality on their French-source income.

This article is not the proper forum to debate the question of whether the United States citizen residing abroad should be taxed like a United States resident or whether United States tax treatment of nonresident citizens should more closely resemble that of all but a handful of foreign countries.[7] The fact is that the picture changed dismally for the United States citizen in 1979. Effective that year, both United States and French tax law changed. The United States eliminated the "earned income exclusion" of

3. CODE GENERAL DES IMPOTS, FRANCE art. 164(1) repealed effective January 1, 1979 [hereinafter cited as CGI]. *See* 3 B. C. INT'L & COMP. L.J. 163 (1978).

4. Lazerow, *The United States-French Income Tax Convention*, 39 FORDAM L. REV. 649, 714-15 (1971); S. EXEC. REP. No. 7, 80th Cong., 2d Sess. 7 (1948).

5. IRC § 911 was repealed effective January 1, 1979, then re-enacted with a vengeance in the Economic Recovery Tax Act of 1981, PUB. L. No. 97-34, § 111, 95 Stat. 172 (1981) (IRC § 911).

6. IRC §§ 901-904.

7. The Philippines and South Korea are countries frequently mentioned as taxing by citizenship.

$25,000 in the developed world, substituting a system of deductions that benefit some United States citizens living abroad greatly, while not benefiting others at all.[8] France abolished its rule exempting non-French source income of alien residents who are taxed by their home country on world-wide income.[9] This abolition subjects Americans residing in France to French tax on their world-wide income. Part of that French tax might not be creditable against United States tax because the United States foreign tax credit has a limitation: it cannot exceed that part of the United States tax which the foreign income bears to total income.[10] Thus, in theory, none of the United States-source income being taxed by France on the basis of the residence of the taxpayer would increase the foreign tax credit limitation so as to permit credit of the French tax. To illustrate, the taxpayer receives $20,000 income from foreign sources plus $40,000 income from United States sources. Credit for foreign taxes paid cannot exceed one-third of the United States tax due ($20,000/$60,000).

The major conflict stems from the fact that the United States believes that citizenship, in and of itself, is an appropriate basis for taxation. Most other countries do not accept this belief. The world does, however, agree that where a country's only contact with the taxpayer is that the taxpayer earns income there, that country may only tax the individual on the income earned there. Likewise, the world generally agrees that a country may tax all in-

8. IRC §§ 911-913. But all is not bleak. A United States citizen who is a resident of France can take substantial deductions under IRC § 913 through 1981 for the cost-of-living differential, high housing expenses, schooling expenses, and certain home travel. *See* Comment, *The Taxation of Americans Living Abroad: The Foreign Earned Income Act of 1978 and §§ 911 and 913 of the Internal Revenue Code*, 19 COLUM. J. TRANSNAT'L L. 79 (1981). Beginning 1982, he can exclude $75,000-$95,000 of earned income (depending on the year) plus excess housing costs. IRC § 911(a)(2).

9. Law n° 76-1234 du 29 décembre 1976, [1976] J.O. 7630; S. EXEC. REP. NO. 96-4, 96th Cong., 1st Sess. 12 (1979) [hereinafter cited as REPORT]. For descriptions of the present law, see G. TIXIER, G. GEST & J. KEROGUES, DROIT FISCAL INTERNATIONAL 21-88 (1979); Cozian, *L'impot sur le revenu en droit fiscal international*, [1980] J.C.P. § 13255; and Note, *supra* note 3, at 163.

10. IRC § 904(a) provides that the foreign tax credit cannot exceed an amount which bears the same proportion to the United States tax that the income from sources outside the United States bears to taxpayer's entire taxable income. The strictness of this limitation is somewhat relieved by the exclusion from "entire taxable income" of the "zero bracket amount" which, under IRC § 63(d), currently ranges from $1,700 to $3,400, depending on the category of return. For a complete discussion of the foreign tax credit, see E. OWENS, THE FOREIGN TAX CREDIT (1961).

come from whatever source of its residents.[11] The United States acquiesce with these principles but goes further, by also taxing the world-wide income of its citizens. When the United States taxes the world-wide income of its citizens residing in France, all parts of that income are equally subject to French tax as well. The result is double taxation. France partially relieves that double taxation by according the taxpayer a deduction for the United States tax paid.[12] While this prevents one-hundred percent of the income from being doubly taxed, it leaves the taxpayer paying a higher effective rate of tax than if he had contact with only one of the two countries.[13] Double taxation is relieved by the United States granting a credit for French tax. The foreign tax credit limitation, however, often prevents this credit from being fully effective with respect to income which the United States considers to be United States-source income.[14] The matter is further complicated by the use in France and the United States of different source rules for certain types of income.

Such a state of events could have serious consequences for the business community. Instead of the free flow of people and ideas across national and cultural barriers that Maitre Azard tried so hard to promote, working in France would become a costly luxury for United States citizens. Treaty relief was needed; treaty relief was granted. A Protocol[15] has been concluded to the United States-France Income Tax Treaty (Treaty)[16] which deals both

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11. RESTATEMENT (SECOND) FOREIGN RELATIONS LAW § 412 comment *a* (T.D. No. 2 1981).

12. CGI, *supra* note 3, art. 39-1-4°; HARVARD LAW SCHOOL, TAXATION IN FRANCE 1966 §§ 11/1.2b, 11/2.8e, 11/2.11a [hereinafter cited as FRANCE].

13. Assume income of $100 from United States sources taxed in both countries at a 50% average rate. United States tax is $50, so a $50 deduction is taken against a French tax, making the French taxable income only $50. The 50% rate is applicable, so taxpayer pays France $25. Taxpayer's effective rate of tax is 75%, 50% to the United States and 25% to France.

14. This is due to the foreign tax credit limitation, see note 9 *supra* and accompanying text. No limit applies to the deduction for foreign taxes under IRC § 164(a)(3). Therefore, in the absence of the Protocol, some United States citizens would profit by taking the deduction rather than the credit, if this did not adversely effect their French tax liability for the same year by reducing the unilateral relief granted by French internal law. REPORT, *supra* note 9, at 14 n.4.

15. Protocol to the Convention between the United States of America and the French Republic with respect to Taxes on Income and Property, July 28, 1967, November 24, 1978, U.S.A.-France, 30 U.S.T. 5109, T.I.A.S. No. 9500 [hereinafter cited as Protocol]. For the French version, see J.O. 26 octobre 1979, [1980] J. DROIT INT'L (CLUNET) 160. A protocol is a document adding to or changing provisions in a treaty in force. The treaty remains in effect except where changed by the protocol. This Protocol was ratified by the United States Senate July 9, 1979, and by a French Decree on October 18, 1979.

16. Convention between the United States of America and the French Republic with respect to Taxes on Income and Property, July 28, 1967, U.S.A.-France, 19 U.S.T. 5280, T.I.A.S. No. 6518 [hereinafter cited as Treaty]. The Treaty is analyzed

with this problem and with other problems that have arisen in the decade since the Treaty was signed. The Protocol is significant for the following reasons:

1. The Protocol takes great strides to accommodate the business community's concern about double taxation;[17]

2. The United States and France exercise unprecedented efforts to divide equitably the tax revenues;[18]

3. The provisions contained in the Protocol unrelated to the domestic law changes outlined above confirm certain directions in treaty policy;[19]

4. The Protocol contains the first known case of a tax treaty permitting discrimination against foreigners solely because of nationality;[20]

5. The Protocol demonstrates the near-impossibility of eliminating all inequities when one builds on human, domestic tax systems;[21]

6. The Protocol sets a strong precedent for future United States tax treaties.[22]

FRENCH RESIDENTS WHO ARE UNITED STATES CITIZENS

Assuming that France and the United States agree on the source of each item of income, French residents who are also United States citizens theoretically have no double taxation problems with income from sources in France or with income from sources outside both France and the United States. Income from sources in France will be taxed by France, and the United States will give a tax credit for that tax up to the amount of

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in detail in Lazerow, *supra* note 4. The relationship of this Treaty to other United States treaties contemporaneously negotiated and to the OECD Draft is discussed at H. LAZEROW, OECD DRAFT INFLUENCE ON UNITED STATES INCOME TAX TREATIES (1976). General introductions to tax treaty problems are found at V. NANDA, THE LAW OF TRANSNATIONAL BUSINESS TRANSACTIONS § 3.02 (1981), P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION 60-78 (1980), J. BISCHEL, INCOME TAX TREATIES (1978), J. BISCHEL & R. FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 203-13 (1977), P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 167-80 (1981).

17. *See, e.g.*, text *infra* at notes 24-34, 40-44, 76-88, 97-105, 112-36.

18. *See, e.g.*, text *infra* at notes 24-34, 40-44.

19. *See*, e.g., text *infra* at notes 146-53.

20. *See, e.g.*, text *infra* at notes 62-63.

21. *See, e.g.*, text *infra* at notes 176-77.

22. *See, e.g.*, text *infra* at notes 34-175.

United States tax on that income. The taxpayer will pay the French tax or the United States tax rate, whichever is higher.

Where the taxpayer realizes income from sources outside both France and the United States, the taxpayer will be subject to income tax in the source country. Relief from double taxation will be granted by France according to its domestic tax law by either exemption from French tax (full relief) or by deduction of the foreign tax paid from taxable income (partial relief). If France has negotiated a tax treaty with the source country, the source-country rate of tax may be reduced or eliminated, or France may either grant a credit against its tax,[23] exempt the income from tax as the residence state, or both. The United States then will again grant a tax credit for the tax at source plus the tax imposed by France up to the amount of United States tax on that income. Thus, the taxpayer will pay tax at the United States rate, or the combined French and source-country tax, whichever is higher.

Double taxation problems arise in two situations: where the French resident-United States citizen recieves income from sources within the United States and where France and the United States disagree on the source of taxpayer's income.

Double taxation on certain United States-source income is relieved by exempting this income from French tax. This is the case for income from realty,[24] business income attributable to a

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23. *E.g.*, Treaty, *supra* note 16, at art. 23(2)(b).

24. Income from realty should be defined in the Treaty, *supra* note 16, at art. 5, art. 23 (2)(a)(i), added by article 1(10) of the Protocol, *supra* note 15. This includes gains from the sale of realty. But France, for purposes of article 23(2)(a)(i) & (b), considers that capital gains on realty are taxable in the United States under article 12. That provision will not support this interpretation. Article 12(1) provides that capital gains are only taxed in the residence state, but article (12)(2)(a) provides that article 12(1) does not apply to gains from realty. It is article 5(1) that permits taxation of gains from realty at source. *See* B.O.D.G.I. no. 37 du 26 février 1980 at 5, 14B-2-80 [hereinafter cited as 1980 Instruction], *France: Tax System Applicable to United States Nationals Domiciled in France under the United States-French Tax Protocol*, TAX MANAGEMENT INT'L J. 17, 18 (1979) where the French result is expressed without supplying the underlying rationale.

The French interpretation leads to ridiculous results. First, income from the property is not taxable in France under articles 5 and 23(2)(a), while gain from its sale would be. In all France's other treaties, income from realty and gain on its sale are taxable only in the country where the realty is located. There is, however, one justification for the French policy. When the Treaty was negotiated, income from United States realty derived by a nonresident alien was taxed by the United States under IRC § 871(a)(1)(A), but gains from the sale of such realty were not taxed by the United States. France should not exempt income which is not taxed in the United States. Beginning June 18, 1980, gains from the sale of United States realty are taxed by the United States. IRC §§ 871, 897. *Compare* Klein, *Investments by Foreign Persons in United States Real Estate*, 2 J. REAL EST. TAX 265 (1975), *with* Klein, *An Analysis of the Foreign Investment in Real Property Tax Act of 1980: How It Works*, 54 J. TAX. 202 (1981). Second, taxation in France raises problems with both subparagraphs of article 23(3) of the Treaty. If gains on realty permanent establishment located in the United States,[25] all income from dependent or independent personal services performed in the United States (except the income of athletes and entertainers).[26] This French tax exemption includes the income of French resident teachers, students, and trainees that would otherwise be exempt from United States tax if the recipient were not also a United States citizen,[27] compensation or pensions paid by the United States or a political subdivision thereof for government services,[28] United States social security payments,[29] and private pensions to the extent attributable to services performed while the taxpayer's principal place of employment was in the United States.[30] Even though these items of income are not taxed in France, France retains the right to compute the taxpayer's tax at a rate appropriate to the taxpayer's full income, including these exempt amounts. The rate to be applied is the average rate that would have been applied if all the taxpayer's income were taxable in France.[31] This is contrary both to the United States result, under which the remaining taxable income is taxed at the lowest

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are taxable in the United States under article 12, then the United States has unlimited taxing jurisdiction and France must credit United States tax up to the French tax paid on the item, and the United States must consider all of the income as from United States sources. *Contra* Simonard, *supra* note 1, at 473 n.96. Third, none of this takes into account the vastly disparate tax laws on gains from real estate. In most cases, because of an inflation adjustment built into basis for the French law, the gain for French tax purposes will be miniscule compared to the gain for United States tax purposes. J. SCHMIDT, FISCALITE IMMOBILIERE 348-53 (2ème ed. 1979); P. COURTOIS, L'IMPOSITION DES PLUS-VALUES 27-240 (1978). In that case, no problem of double taxation will be posed for the United States citizen-French resident. There may also be, however, instances where tax is imposed by France, but the United States defers recognition of the gain. *See, e.g.*, IRC §§ 1031, 1033, 1034, 121 (though it may be difficult for a French resident to have a principal residence in the United States). In such a case, there would be no United States tax to credit against the French tax, as the United States tax would be imposed in a future year when the exchanged property is disposed of.

25. *See* Treaty, *supra* note 16, at arts. 4, 6, 9(3), 10(4), 11(5) & 12(2)(b) plus art. 23(2)(a)(i) added by the Protocol, *supra* note 15.

26. *See* Treaty, *supra* note 16, at arts. 14 & 15 plus art. 23(2)(a)(ii)(*a*) added by the Protocol, *supra* note 15.

27. *See* Treaty, *supra* note 16, at arts. 17 & 18 plus art. 23(2)(a)(ii)(*b*) added by the Protocol, *supra* note 15.

28. *See* Treaty, *supra* note 16, at art. 16 plus art. 23(2)(a)(i) added by the Protocol, *supra* note 15.

29. *See* Treaty, *supra* note 16, at art. 20 plus Protocol arts. 1(8) and 1(10) amending art. 20 and adding art. 23(a)(2)(i) to the Treaty, *supra* note 15.

30. *See* Treaty, *supra* note 16, at art. 19(1) plus art. 23(2)(a)(ii)(*c*) added by the Protocol, *supra* note 15.

31. REPORT, *supra* note 9, at 11, 38-39 (text), 59.

appropriate rate, and to the author's assumption that under the Treaty it would be taxed at the highest appropriate rate.[32] Double taxation on other income is avoided by recognizing the superior right to tax of the residence state,[33] which is frequently done by the United States changing the source of what would otherwise be United States-source income to foreign-source income.[34]

Partners[35]

Under the domestic tax laws of France and the United States, the source of partnership income is determined differently, and certain partnerships are taxed in a different fashion. This creates double taxation problems for all partners, but especially for French residents who are United States citizens.

Domestic law source rules

Under United States law, each partner is considered to have earned that proportion of partnership income and to have incurred that proportion of partnership deductions that corresponds to his proportionate interest in the partnership (unless there is a valid special allocation).[36] This is called the partner's "distributive share." The distributive share of each partner includes a

32. Lazerow, *supra* note 4, at 718-19.

33. J.O. Déb. AN 6 June 1979, at 4695. Burge, *Status of Tax Treaty Negotiations*, 24 BULL. INT'L FISCAL DOC. 55, 58 (1980).

34. INT'L TAX REP., Dec. 26, 1978 at 6, suggests that the Convention Between the United States and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 9, 1970, U.S.A.-Belgium, 23 U.S.T. 2689, T.I.A.S. No. 7463 [hereinafter cited as Belgian Treaty] was the general precedent for the Protocol. More specifically, it has been suggested that there are rulings under the Belgian Treaty that change the source of income in order to relieve double taxation. *Proceedings of the U.S.A. Branch IFA Technical Session of March 15, 1979*, BULL. INT'L FISCAL DOC. 55, 60 (1980); Simonard, *supra* note 1, at 455-56 n.4 (referring to the Convention Between the United States and Japan, Double Taxation: Income, March 8, 1971, U.S.A.-Japan, 23 U.S.T. 967, T.I.A.S. No. 7365, presumably arts. 5(1)(a) and 6. While this is true, the solutions adopted vary greatly from the French Protocol. *See* Belgian Treaty, arts. 14-16, 23(2) and 23(3). Article 23(2) reads, "Income which has been taxed by Belgium in accordance with articles 6 through 21 shall, for the purpose of applying the United States credit in relation to Belgian tax, be treated as income from Belgian sources." *See also* Rev. Rul. 79-128, 1979-1 C.B. 457 and Rev. Rul. 79-206, 1979-2 C.B. 279. *Compare* the Convention Between the United States and Finland, Double Taxation: Taxes on Income and Property, March 6, 1970, U.S.A.-Finland, 22 U.S.T. 40, T.I.A.S. No. 7042 arts. 5(1) and 6, *with* the less specific provisions of the Convention Between the United States and Trinidad and Tobago, Double Taxation: Taxes on Income, January 9, 1970, U.S.A.-Trinidad and Tobago, 22 U.S.T. 164, T.I.A.S. No. 7047, arts. 4(1) and 5.

35. For general treatment of partnerships under treaties, see Loengard, *Tax Treaties, Partnerships and Partners: Exploration of a Relationship*, 29 TAX LAW. 31 (1976).

36. IRC § 704.

share of each type of income derived from sources within each country in which the partnership earns income.[37] This general rule is subject to two exceptions. First, when the partner only receives a share if there is income from a specific source, all of that partner's share is income from that source. Second, when the partner receives a guaranteed payment regardless of partnership earnings, the payment is considered to be for services as though paid under an employment contract, and the payment has its source in the place where the partner's services are rendered.[38]

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37. IRC §§ 701-704; REPORT, *supra* note 9, at 12-13, 43-44. To illustrate, assume that a taxpayer is a 75% partner in a partnership with $300,000 of income from sources within the United States, $40,000 of which is from long term capital gains to which no deductions are attributable. The other $260,000 is United States-source business income to which $200,000 of deductions are attributable. The partnership also has $400,000 gross income from sources outside the United States to which $300,000 in deductions are attributable. The taxpayer has $30,000 United States-source long term capital gain (.75 × $40,000) and $45,000 of net United States-source business income (.75 × $260,000) less (.75 × $200,000). Net business income from foreign sources (as well as net foreign-source income) is $75,000 (.75 × $400,000) less (.75 × $300,000). The taxpayer would be subject to United States tax at ordinary income rates on the business income and at the special reduced rate on the capital gains income. Within the limits of IRC § 904, a taxpayer may take a credit for 75% of the foreign income tax paid on the business income from foreign sources. Rev. Rul. 67-158, 1967-1 C.B. 188.

38. Illustration of the first exception: Under the partnership agreement, the taxpayer is to receive 100% of the foreign-source net income plus 50% of the United States-source net income, the allocation has some economic effect, and the income is as stated in note 37 *supra*. The taxpayer has $20,000 United States-source long term capital gain (.50 × $200,000), $30,000 United States-source net business income [(.50 × $260,000) less (.50 × $200,000)], and $100,000 net foreign-source business income [1.00 × ($400,000-$300,000)]. The taxpayer would be subject to United States income tax at ordinary income rates on the business income ($130,000). Provided the rate of foreign tax is not too high, the taxpayer may credit up to 100% of the foreign income tax paid by the partnership (or by the partner) on the foreign income. Since all the foreign income is allocated to taxpayer, the other partner(s) have only United States-source income. *See* IRC § 704(b).

Illustration of the second exception: Under the partnership agreement, the taxpayer is to receive a guaranteed payment of $75,000 per year, plus 75% of all partnership income in excess of $100,000. Partnership income is the same as in note 37 *supra*. The taxpayer performs all his services for the partnership outside the United States. He has services income from outside the United States of $75,000, the amount of the guaranteed payment. The partnership's earnings are $200,000, so the taxpayer is entitled to an additional $75,000 [($200,000−$100,000) × .75]. It is paid from the $125,000 in partnership income remaining after the guaranteed payment. The $125,000 is composed of $25,000 net foreign-source business income ($400,000−$300,000−$75,000), $40,000 net United States-source capital gain, and $60,000 net United States-source business income ($260,000−$200,000). The ratio of payment to the taxpayer to remaining net income is $75,000/$125,000, or 60%. The taxpayer's remaining payment is composed of $15,000 net foreign-source business income (.60 × $25,000), $24,000 net United States-source capital gains income (.60 × $40,000), and $36,000 net United States-source business income (.60 × $60,000).

The French source rule for partners who perform services outside France is the same as the general United States rule: a *pro rata* share of income from each partnership source. However, the rule for a partner who performs services in France is that all of his partnership income is considered to be from French sources.[39] This means that the partners in the aggregate may have more French-source income than the partnership does where any partner performs services in France.

The rule also creates unrelieved double taxation for the United States citizen-French resident partner performing his services in France where the partnership itself derives income from sources within the United States. France taxes the partner on one-hundred percent of his income because it is the source country (where the services are performed) and gives no double taxation relief; the United States taxes all of the income because of the taxpayer's citizenship, but gives a tax credit only for the portion of the income tax due on foreign-source income determined under United States law. If the partnership derives ninety percent of its income from United States sources, the United States will give the foreign tax credit against only ten percent of the United States tax.

Treaty source rules and elections

The Protocol strikes a compromise that promises some relief from double taxation in every case, and full relief if the partner affected can (or wishes to) persuade the partnership to elect it. First, the Protocol establishes the general principle that income of a partner from a partnership has the same source *pro rata* as the income did in the hands of the partnership.[40] This is the United States rule and the French rule for partners who work for the partnership outside France. For partnerships in the liberal professions,[41] however, no more that fifty percent of the earned income of a United States citizen residing in France will be exempt from French tax under that general principle.[42] Further, that in-

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Thus, the taxpayer's net foreign-source income is $90,000 ($75,000 guaranteed payment plus $15,000 net foreign-source business income). *See* IRC § 707(c).

39. REPORT, *supra* note 9, at 13, 44. *See* text *infra* at notes 58-64 for comments on what the rule in French domestic tax law really is.

40. Protocol, *supra* note 15, at art. 1(3) adding art. 6(4) to the Treaty, *supra* note 16.

41. It is not clear whether this rule applies strictly to the liberal professions or is more general. 1980 Instruction, *supra* note 24, at 6 uses the term "exercising an activity of an independent character." Such a term may be broad enough to include all activities taxed by France as non-commercial income "BNC" except that which is specifically covered by other Treaty articles.

42. Protocol, *supra* note 15, at art. 1(6) adding art. 14(6) to the Treaty, *supra*

come which is not exempt from French tax will be considered French-source income for United States tax purposes, if and only if the partnership so elects.[43]

The result of these three provisions is that where there is a French-resident partner who is a United States citizen in a service partnership with more than fifty percent United States-source income, fifty percent of the partner's distributive share will be taxed in France. The entire distributive share will be taxed in the United States because of the taxpayer's citizenship, however, a credit will be given for tax on income from sources outside the United States. If the partnership so elects, all the income taxed by France will be from sources within France, giving a tax credit for fifty percent of the United States tax. The final result relieves the partner of double taxation while splitting the revenue more-or-less equally between the two countries, instead of allocating the lion's share to one country as is done in the rest of the United States tax treaties.[44]

What of payments dependent on the source of the income? The United States rule continues to apply, making source-dependent income retain that source subject to the fifty percent limit discussed above.[45]

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note 16. The exemption results for Protocol art. 1(10) adding art. 23(2)(a)(i) to the Treaty, providing for exemption from French tax for income taxed in the United States to a United States citizen other than by reason of citizenship. The source rule change means that the income is taxed in the United States because it is sourced there by agreement of the two countries. *See* text *supra* at notes 24-32.

43. Protocol, *supra* note 15, at art. 1(10) adding art. 23(3)(c) to the Treaty, *supra* note 16. The matter becomes more complicated beginning in 1982, when United States citizens who are foreign residents may exclude from gross income substantial amounts of foreign source earned income under IRC § 911. Thus, both French and United States tax will depend on the source of partnership income. Then article 23(3)(c) ends: "This provision shall not result in a reduction of United States tax below that which the taxpayer would have incurred without the benefit of deductions or exclusions available *solely* by reason of his presence or residence outside the United States." [Emphasis added]. This sentence seems designed to prevent use of this Treaty provision to increase the foreign earned income exclusion by increasing the amount of foreign earned income while permitting the foreign tax credit limitation to be expanded by increasing the foreign-source income for that purpose. This problem disappears if the partnership makes a full reallocation election. *See* text *infra* at notes 64-65.

44. *Compare* Treaty, *supra* note 16, at arts. 5-7, 12, 14-20 (allocating full taxing jurisdiction to either the source or the residence county), *with* arts. 9-11 (allowing the source country to tax at between 5% and 15% but leaving the rest of the taxing jurisdiction to the residence country).

45. Protocol, *supra* note 15, at art. 1(3) adding art. 6(4) to the Treaty, *supra* note 16.

Guaranteed payments

The treatment of guaranteed payments is not so clear. No mention is made in the Treaty of guaranteed payments. One could, therefore, conclude that the general rule of new article 6(4) of the Treaty applies to place the source of guaranteed payments (*pro rata*) with the source of partnership income, not duplicating the exception in United States law. On the other hand, either country is free to argue that this is a provision undefined in the Treaty, and ". . .any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of the Convention."[46] Guaranteed payments to a French resident would be sourced in France under United States law because the services are performed there and under French law because the taxpayer is a French resident. The senate report says that article 6(4) does not apply to guaranteed payments.[47] That is certainly the most sensible result because it conforms to the domestic law of both countries,[48] but it is not an easy result to reach under article 6(4).

Partners in the Liberal Professions[49]

There is a second technical problem with the Treaty solution. France need not exempt from French tax more than fifty percent of the earned income from a partnership in the liberal professions. The Protocol does not define "earned income." The senate report states that earned income includes guaranteed payments[50]

46. Treaty, *supra* note 16, art. 2(2).

47. REPORT, *supra* note 9, at 14, 43-44. France agrees. *See* 1981 Note, *supra* note 1, at 9.

48. The United States sees guaranteed payments untied to earnings as neither more nor less than salary, to be sourced where the services are performed unless the payments were for capital or other nonservice items. Edward T. Pratt, 64 T.C. 203 (1975), *aff'd in part* Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977), Rev. Ruls. 81-300 through 301, 1981-51 I.R.B. 11-12. France does not consider guaranteed payments to be salary, but rather non-commercial income. Salary income is entitled to a 10% reduction for professional expenses and an exemption of 20% of the resulting total. 1981 Note, *supra* note 1, at 9.

49. "Liberal profession" is a term of art in French tax law. It requires that one be independent (not an employee) and engaged in a professional activity (not one that is industrial, commercial, or artisanal). Included are independent lawyers, accountants, doctors, artists, auctioneers, etc. *See* note 50 *infra* and accompanying text.

50. REPORT, *supra* note 9, at 14. It has been argued that France excludes guaranteed payments from the total partnership earnings to which the 50% liberal profession maximum exemption because the regulations example does not mention guaranteed payments. 1980 Instruction, *supra* note 24, at 6. But the omission does not justify the interpretation placed on it, an interpretation that would make avoiding double taxation much more difficult and directly contradicts the United

but goes no further. Earned income is a term of art in United States law, employed in the exclusion for foreign earned income,[51] in the maximum tax on earned income[52] and the earned income credit,[53] and also implied in the distinction between partnerships where capital is a material income-producing factor and those where it is not.[54] Under some of these provisions, where capital is a material income-producing factor for the partnership, only part of the partnership income would be earned income, and that earned income cannot exceed thirty percent of the total net income of the partnership.[55] The rest of the partnership income would be income from capital. As France is willing to give up the right to tax all income from capital but only fifty percent of the earned income, only $15,000 would be taxed in France to a partnership with $100,000 in income but only $30,000 in earned income, all from sources in the United States. All the unearned income ($70,000) and half the earned income ($15,000) would be from United States sources.

At first blush, such a division of revenues between the countries seems too generous on France's part. It raises suspicions that United States law was not fully explained during the negotiations. The French language version of the Treaty translates "earned income" as "*revenus*",[56] which is not limited to earned income. Reflection reveals, however, that the result is perfectly con-

States legislative history. 1981 Note, *supra* note 1, at 9 specifically includes guaranteed payments in earned income.

51. IRC § 911; J. CHOMMIE, FEDERAL INCOME TAXATION 38-39 (2d ed. 1973) [hereinafter cited as CHOMMIE].

52. IRC § 1348; CHOMMIE, *supra* note 51, at 476-77. Section 1348 was amended to eliminate the 30% rule for maximum tax on earned income purposes only. *See* IRC § 1348(b)(1)(A).

53. IRC § 43(c)(2).

54. IRC § 704(e); CHOMMIE, *supra* note 51, at 476-77. *See* David M. Treatmen, 41 T.C.M. (CCH) 934 (1981), where capital was a material income-producing element in a mail-order business where a taxpayer had minimal inventory, but bought expensive mailing lists and used customer prepayments to finance purchases.

55. IRC § 911(d)(2)(B). The statute calls for the Treasury Secretary to issue regulations governing this allocation. Those regulations simply repeat the words of the statute, rather than setting forth detailed allocation suggestions or even cross-referencing the regulations under IRC § 482. *See* Treas. Reg. § 1.911-1(a)(5) - 2(c)(3) (1963). Treas. Reg. § 1.482-2(b)(3) (1974) suggests the amount which would have been charged for the same services in independent transactions between unrelated parties under similar circumstances. IRC § 43(c)(2) does not appear to incorporate the 70%-30% split, as it refers to IRC § 1402, which seems to include all partnership income, and is not limited to 30%.

56. Treaty, *supra* note 16, at art. 14(4).

sistent with the rest of the Treaty. France exempts business income attributable to a permanent establishment in the United States.[57] That income is equivalent to a partnership's income from capital.

The fifty percent rule was inserted to assure that quick juggling of corporate books did not eliminate the taxability of income from services performed in France.[58] Perhaps the best way to avoid double tax problems here is to provide a guaranteed payment of more than half the partner's expected share. This will satisfy the French desire to tax at least fifty percent of the income, yet that entire tax will be creditable on the partner's United States tax return without any partnership election because United States domestic law considers guaranteed payments sourced where the services are performed.[59]

It is to be noted above that the Protocol refers to services performed by a French resident, while the senate report phrases it in terms of services performed in France. It should be noted that many French-resident partners in law firms perform substantial services outside France in representing clients. While the principal place of employment may be France, the partner may spend many months during the year working in other countries.[60] There is no suggestion of a daily or even monthly allocation, implying that the relevant figure is fifty percent of the earned income of a French resident.

It is appropriate to ask whether this problem is realistic. Is not one-hundred percent of the income of a partnership in a liberal profession from services? The number of liberal professions is

57. *Id.* at arts. 6, 23(2)(a).

58. The fifty percent rule prevents the artificial allocation of income to foreign sources.

59. It can be argued that this solution will not work because France will not count guaranteed payments in computing the 50% that will be taxable in France. This argument derives from the last sentence of paragraph I.6 of the 1980 Instruction, *supra* note 24, which reads: "However, these taxing rules do not govern remuneration in the form of 'guaranteed payments' allocated to partners in partnerships." The better view is that the reference to "these taxing rules" is a reference to previous provisions of I.6 sourcing each partner's income where the partnership derives its income and providing that French resident partners are exempt from French tax on United States-source partnership income, unless they are United States citizens. Such an interpretation is logical, because the tax treatment of French residents who are also United states citizens is dealt with in paragraph II of that instruction. That interpretation also conforms to REPORT, *supra* note 9, at 14, making the United States and French interpretations identical. It now also conforms to the United States law. *Compare* Kampel v. Commissioner, 80-2 USTC ¶ 9816 (2d Cir. 1980), *with* IRC § 1348 as amended, giving the IRS discretion to determine what portion of a guaranteed payment is earned income without regard to the 30% limitation. 1981 Note, *supra* note 1, at 9 counts guaranteed payments in "earned income."

60. For a comparable situation, see Herbert A. Filler, 74 T.C. 406 (1980).

large, including sculptors where the use of capital certainly exists. If the term is read expansively, it would include many quasimonopolies that are bought and sold, such as the *notaire* and the *avocat à la cour de cassation et au conseil d'état*, where the purchase of the office may entail a substantial fee.[61]

Discrimination against United States citizens

The third problem with the fifty percent rule, and certainly the most severe from a policy standpoint, is that it breaches the principle of nondiscrimination. Each tax treaty contains a nondiscrimination article providing that a citizen of one country residing in the other country shall not be subject to more burdensome taxes than a resident citizen of the taxing country.[62] The result of the fifty percent rule is that where a partnership in the liberal professions has two partners who are French residents and receives more than fifty percent of its income from outside France, the French citizen will be taxed in France only on the percentage of income from France, while the United States citizen will be taxed on fifty percent of his partnership share.[63] The nondiscrimination article does not change this result, both because the discriminating provision governs, being later in time, and because the more specific discriminating provision governs the more general nondiscrimination provision. Such discrimination is to be regretted in domestic tax law; it should be deplored when sanctified by treaty.

Partnership elections

The provision that provides full relief from double taxation for partnership income is that which permits the partnership to elect to treat income from French sources.[64] If this provision is an appropriate resolution of the problem, why is it not mandatory? There are two reasons: the partnership must pay two prices for this election. First, where the election is made by the partner-

61. For a list, see F. LEFEBVRE, IMPOTS DIRECTS BNC §§ 541-2123.

62. *E.g.*, Treaty, *supra* note 16, at art. 24. Two articles discussing problems in the standard non-discrimination clause are O'Brien, *The Nondiscrimination Article in Tax Treaties*, 10 LAW & POL. INT'L BUS. 545 (1978) and Gifford, *Permanent Establishments under the Nondiscrimination Clause in Income Tax Treaties*, 11 CORNELL INT'L L.J. 51 (1978).

63. 1980 Instruction, *supra* note 24, at 6.

64. *See* text *supra* at note 43.

ship, none of the partners can take advantage of the earned income exclusion[65] or the deduction for certain expenses of living abroad.[66] While it is unlikely that the earned income exclusion would be available to any French resident, other partners residing in developing countries may wish to use it[67] and would oppose the partnership election. It is also possible that, for an individual taxpayer, the benefits of the deduction for expenses of living abroad would outweigh the benefits of the election. This is especially true for partners based in France, where Internal Revenue Code (IRC) section 913 deductions in excess of $15,000 are not unusual for a married couple with children in school.[68] In such a case, the taxpayer to be benefitted would often prefer the section 913 deduction. Even where the partner would prefer treaty election relief, some other partner may prefer the section 913 deduction. Since the interests of one partner may be opposed to those of another, the matter is left to negotiation within the partnership.

The second price that must be paid for the election is a price that must be paid by the other partners. The Treaty's intent is that the overall income of the partnership be sourced where earned by the partnership. If the distributive share of one partner has a higher than normal proportion of French-source income, the share of the other partners will have a lower than normal proportion of French-source income. This reduces the foreign tax credit limitation of the other partners and may thereby reduce the amount of their foreign tax credit. It may even change the source of unrelated income during that taxable year, or carry over to the succeeding year.[69] While the election is binding on all partners and presumably made in the same way as other partnership elections, it is only made year-by-year. Thus, the question is likely to be renegotiated annually in the partnership meeting.

Subchapter S corporations

No reference is made in the Protocol to that griffon of United

65. IRC § 911.

66. IRC § 913.

67. Effective January 1, 1979, this exclusion is confined to persons residing in a camp in a hardship area. IRC § 913(h)(2) defines hardship area in a way that excludes the developed world. Imagine a partnership composed of residents of the United States, England, France, Brazil, and Saudi Arabia.

68. The benefits of this deduction depend on the country involved and the extent of family responsibilities. Single taxpayers are unlikely to have large deductions, as their travel and living costs are lower than a family's costs; and, lacking children, there is no tuition deduction.

69. REPORT, *supra* note 9, at 16, 54-55; Protocol, *supra* note 15, at art. 23(3)(c)(ii).

States tax law, the subchapter S corporation.[70] A subchapter S corporation is technically a corporation, but is treated for many (but not all) United States tax purposes as though it were a partnership. Principally, the corporation is not taxed on its income. Rather, the shareholders are taxed on their *pro rata* share of the income, whether distributed or not. Subchapter S corporations should be considered corporations under the Treaty, since a United States corporations means "a corporation . . . which is created or organized under the laws of the United States or any State thereof. . . ."[71] No special relief is provided by the Protocol. While this can be justified on the ground that France does not accord partnership treatment to any corporation in its tax law, thereby avoiding the kind of double taxation problems referred to above, more complicated double taxation problems surely result from taxation as a corporation in one country and as a partnership in the other. Taxation of United States citizens residing in France on world-wide income will exacerbate those problems. Perhaps the ultimate justification for not examining these double taxation problems is that subchapter S status is elective. Shareholders should examine the double taxation problems before making the election.

Limited partnerships

The limited partnership faces a similar situation. In the United States at least for the moment, a limited partnership is not taxed, the Internal Revenue Service having lost its contention that a limited partnership has more corporate than partnership characteristics.[72] Each partner's *pro rata* share of partnership income is taxed to that partner as earned, whether distributed or not.

In France, the tax regime of a partnership depends on the liability of the partner. Any partner with unlimited liability is taxed on his distributive share of partnership income, whether distributed or not, and the partnership is not subject to tax on that income. A

70. IRC §§ 1371-79; CHOMMIE, *supra* note 51, at 543-53. A subchapter S corporation cannot receive more than 80% of its income from sources outside the United States. IRC§ 1372(e)(3). Nonresident aliens cannot be shareholders in subchapter S corporations, but United States citizens residing abroad can be.

71. Treaty, *supra* note 16, at art. 2(1)(d)(i).

72. P.G. Larson, 66 T.C. 159 (1976). *See* Treas. Reg. § 301.7701-1(c), -2 (1977), -3 (1960); *Report on Foreign Tax Entity Characterization for Federal Income Tax Purposes*, 35 TAX L. REV. 167, 191-92 (1980); Rev. Rul. 79-106, 1979-1 C.B. 448.

limited partnership is a taxable entity, paying company tax on the distributive shares of all limited partners. A partner with limited liability is taxed on income actually distributed to him as though it were a dividend, and the partnership is also taxed on that income.[73] Thus, a limited partnership of the United States doing business in France would pay a French corporate tax on income attributed to the limited partners who, if they are French residents, would be entitled to the *avoir fiscal*[74] when those profits are distributed to them. Meanwhile, without having received any payment, they are subject to United States income tax on their distributive shares. They should, however, be entitled to a foreign tax credit for the corporate tax the partnership paid to France.[75]

Retired Persons

The Protocol affects taxation of retired persons on social security, private pensions, and investment income in general.[76]

Social Security

Definition

There is no definition of "social security payments" in the Treaty or its legislative history. Unless the context otherwise requires, undefined terms are defined under the law of the state imposing the tax.[77] Here, however, the context otherwise requires. Social security payments are taxable only by the paying state.[78] The purpose is to coordinate the tax treatment of contributions and benefits. Therefore, "social security benefits" should be de-

73. CGI, *supra* note 3, at art. 8 and arts. 205-08, especially art. 206(4); M. COZIAN, PRECIS DE FISCALITE DES ENTERPRISES 162-67 (1978).

74. The *avoir fiscal* ameliorates the taxation of corporate profits on both company and shareholder levels. The company pays 50% company tax. The shareholder takes credit for half that tax. The shareholder "grosses up" the dividend received by 50% and takes a tax credit for that amount. *E.g.*, Taxpayer receives 100FF dividend, reports 150F income, and takes a 50F credit against the shareholder's tax liability. *See* Norr, *The French Reform of Dividend Taxation and Common Market Tax Harmonization*, 44 TAXES 320 (1966); L. HALPERN, TAXES IN FRANCE 46-52, 54-55 (3d ed. 1980).

75. The indirect foreign tax credit would not be available because under United States law a Taxpayer is not receiving a distribution from a corporation, even though that is precisely the position under French law. IRC § 902. The taxpayer should argue that since United States law considers the partnership income to be the taxpayer's, it should also consider that the French corporate tax was paid *pro rata* by the taxpayer and, therefore, is creditable under IRC § 901. IRC § 901(b)(4); E. OWENS, THE FOREIGN TAX CREDIT 402-08, 423-25 (1961).

76. Provisions relating to investment income will be discussed in the next section of this article.

77. Treaty, *supra* note 16, at art. 2(2).

78. *Id.* at art. 20.

fined by the law of the paying state for purposes of the imposition of taxes in both states. United States social security payments are those paid under the social security laws of the United States and French social security payments are those paid under the social security laws of France.

This will create an asymmetrical situation. The social security systems of both states pay retirement benefits, other benefits, however, such as disability payments, survivors payments, medical reimbursements, family allowances, unemployment benefits, or other welfare payments, may be considered social security benefits by one country but not by the other. Local law must be consulted.[79]

Social security payments must be made by the state or an instrumentality thereof because the provision applies only to payments "paid by one of the Contracting States."[80] Private payments do not qualify, though it might be argued that, should a private insurance scheme be considered social security by one of the states, have mandatory contributions, and a pay-out guaranteed by the state, this should be considered a social security payment by the state because of the state's heavy involvement.

Exemption of Benefits

The Treaty provides that social security payments to a resident of the other state are taxable only by the paying state.[81] Thus, a United States citizen who retires on United States social security in Brittany is not taxed in France on that payment. Much more common, however, is the person who retires in the country of past employment. An American who worked then subsequently retired in France would be subject to a tax by France on French social security payments. That American would also be subject to a United States tax on those French social security payments because the taxpayer is not a United States resident to quality for Treaty benefits.[82] The Protocol expressly extends the benefits of

79. For that reason it appears that when a United States citizen is reimbursed for medical expenses by a private United States insurer and again reimbursed by French social security, the social security reimbursement does not constitute taxable income in the United States under the Treaty. Although many non-retirement social security benefits are exempt from tax in each country, the text discussion is limited to social security retirement benefits for simplicity.

80. Treaty, *supra* note 16, at art. 20.

81. *Id.* at arts. 20, 22(4)(a).

82. REPORT, *supra* note 9, at 10, 48; Rev. Rul. 75-498, 1975-2 C.B. 511.

the social security article to United States citizens without any limitation as to residence: they may be taxed only by the country making the payment.[83]

One might ask why this provision is necessary. French social security retirement payments would be taxed both by the United States and by France. The United States would grant the foreign tax credit for these payments if they are from French sources.[84]

Curiously, no United States precedent exists on the source of social security payments. There is French precedent assuming (but not actually deciding) that the source of social security payments received for work in the paying country is the paying country.[85] Three alternate rationales are possible. Social security payments can be considered part of the compensation for personal services, in which case their source under IRC section 861(a)(3) would be the place where the personal services are to be performed. In many cases, this will require an allocation because the taxpayer may have worked in several different countries while paying social security taxes to the same state.[86]

If viewed as a subsidy, the source of social security payments would be the place where the subsidized activity is to take place. This might also require allocation, but of a different sort. Most social security systems have a series of assistance (such as health) benefits and a basic level of retirement benefits that are not dependent on past or present employment. There, the subsidized activity seems to be the taxpayer's residence. For additional retirement benefits paid on the basis of past work-related contributions, the allocation based on place of work should apply.[87]

The third possible theory, by analogy to interest paid or to alimony, is that the payer provides the source of the income.[88]

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83. Protocol, *supra* note 15, at art. 1(8) amending art. 20 of the Treaty, *supra* note 16. The United States Model, *supra* note 1, arts. 9(4)(a), 18(1)(b) adopts the same solution of taxation by the payor, but this may apply only to social security retirement benefits, as article 18(1)(b) reads, "social security benefits and *other* public pensions. . ." [emphasis added]. *See* text *supra* at notes 77-79.

84. *See* text *supra* at note 10.

85. M. EDWARDES-KER, INT'L TAX TREATIES SERVICE (N.D.) [hereinafter cited as INT'L TAX TREATIES] 19/5-6, translating Rep. Martin J.O. Déb. Sén. April 5, 1974 #14126, at 255.

86. *See* text *infra* at note 100.

87. It is not clear whether Rev. Rul. 73-252, 1973-1 C.B. 337 is based on the subsidy theory or the personal services theory.

88. IRC § 861(a)(1); Manning v. Commissioner. 80-1 USTC ¶ 9211 (1st Cir.); S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS & NONRESIDENT ALIENS VI/D (1969). Walter A. Howkins, 49 T.C. 689 (1968). *See* Rev. Ruls. 66-34, 1966-1 C.B. 22 and 76-121, 1976-1 C.B. 24 which hold foreign social security payments taxable to United States residents, but do not address the question of their source.

Under any of these three theories, French social security payments to a United States citizen who worked in France then retired in France would be French-source. As a result the United States would grant the foreign tax credit for French taxes on it. The taxpayer would pay the higher of the French or the United States rate of tax, and the United States would not consider that double taxation had occurred.

The Protocol completely exempts French social security payments from United States tax. The theory may be that one government should not tax the other's social security payments or may be that the analogy to United States social security payments, which are not taxed to the recipient, should prevail. Many retired United States citizens living in France will have no other income than social security benefits, so the exemption from United States tax would spare them the necessity of filing a United States tax return. Also, some governments allow deductions for social security tax payments but tax benefits, while others permit no deductions for contributions but exempt benefits.[89] Such a rule would in theory harmonize the tax treatment of contributions and benefits, as they would both be subject to the same state's rules.

Creditability of French Social Security Taxes

The senate report points out a benefit that the Protocol does not foreclose.[90] The United States grants a foreign tax credit for foreign income tax paid on foreign source income. It is likely that courts would rule that French social security taxes are foreign income taxes.[91] This would permit the taxpayer to reduce the United States tax, dollar for dollar, with his French social security

89. *See* Lazerow, *supra* note 4, at 711-12.
90. REPORT, *supra* note 9, at 10.
91. Even under recent revenue rulings such as Rev. Rul. 78-62, 1978-1 C.B. 226, and under Prop. Treas. Reg. § 1.901-2, especially ¶ (a)(3)(iv) thereof the IRS seems to specifically permit social security taxes to be considered income taxes unless imposed under an agreement pursuant to § 233 of the Social Security Act. Temp. Treas. Reg. § 4.901-2(b)(4). French social security tax is exacted only on realized net income in the United States sense. *See* James R. McGowen, 67 T.C. 599 (1976) and Anthony Trujillo, 68 T.C. 670 (1977), holding that state disability taxes measured on a minimal amount of income are deductible state income taxes under IRC § 164. The IRS has so ruled for mandatory payments measured by income, even when paid under a program limited to certain professions. Private letter ruling from J.R. Ryals to the American Chamber of Commerce of France, Inc., April 30, 1974.

tax payments. When the taxpayer receives French social security benefits, they will not be subject to a United States tax, thereby transferring the entire burden of French social security taxes from the taxpayer to the United States Treasury with no possibility of later recoupment. But that is not all. In France, social security tax payments, whether made by the taxpayer or by the taxpayer's employer, are excluded from the taxpayer's gross income.[92] When the individual receives French social security retirement benefits, the benefits are taxable unless the recipient's income is small.[93] The United States citizen, therefore, reaps the benefit of substantial deferral, for the taxpayer takes the foreign tax credit long before the year in which any adverse French tax consequences occur,[94] and the taxpayer still may avoid eventual taxation. The United States position is that these taxes will cease to be creditable when the United States reaches a totalization agreement with France,[95] a position with which the courts may not agree.[96]

Private Pensions

Private pensions have always been taxable at the taxpayer's residence, always reserving the right of the United States to tax its citizens.[97] A United States citizen residing in France who had worked all his life in the United States would be subject to double taxation on his pension income. France would tax such income because of residence and the United States would tax it because of source and citizenship. The entire pension would be considered for United States tax purposes as income from sources within the United States because it accrued as a result of United States work and it went into a United States fund.[98] The foreign tax credit limitation would likely preclude any foreign tax credit for tax paid to France on the pension. The Protocol provides that

92. CGI, *supra* note 3, at arts. 81-9°, 83-2°; Lazerow, *supra* note 4, at 711-12.

93. The 1978 limits for those over 65 are 18,300 F. CGI, *supra* note 3, at art. 5-2°, 5-2° bis; FRANCE, *supra* note 12, at 8/1.9b n.40 and 12/1.6c.

94. While a taxpayer does not include the amounts paid for French social security tax in gross income for French income tax, it is assumed that such an amount would be included in gross income for United States tax purposes. This would certainly be true if the amount of the tax were claimed as a foreign tax credit. The advantage still exists because the inclusion would increase taxpayer's United States tax by no more than 50% of its amount, since it would be earned income subject to the maximum tax on earned income under IRC § 1348, while the credit provides $1 of benefit for each $1 of inclusion.

95. Prop. Treas. Reg. § 1.901-2(a)(3)(iv); Rev. Rul. 79-291, 1979-2 C.B. 273; Temp. Treas. Reg. § 4.901-2(b)(4) (1980).

96. *See* note 91 *supra*.

97. Treaty, *supra* note 16, at arts. 19(1), 22(4)(a).

98. Rev. Rul. 72-149, 1972-1 C.B. 218; REPORT, *supra* note 9, at 16, 50. *See also* Rev. Ruls. 79-388-389, 1979-2 C.B. 270, 281.

France will exempt from its tax private pension income "attributable to services performed while [a taxpayer's] principal place of employment was in the United States."[99] No method is set forth for determining what part of the pension is attributable to a particular country in the event of a working life split between a number of countries, but the fairest and most easily administered system would be on the basis of time, rather than on the basis of contributions.

It could be argued that the allocation should be made on the basis of the size of the premiums contributed by or on behalf of the taxpayer, while his principal place of employment was the United States, compared to the total contributions. In an economy subject to severe inflation, where one's jobs are usually more responsible toward the end of the career and therefore better paid, and in a negotiating period when employee organizations seek and receive an ever-greater percentage of pension contributions from their employers, such a system would give great weight to the more recent contributions. Two factors, on the contrary, support the proposition that earlier contributions should be given more than their dollar amount's weight in the allocation. First, because of inflation, dollars contributed long ago were in fact worth more in terms of what they bought, and the entire amount of contributions should be calculated on the basis of real economic contributions, rather than nominal monetary amounts. Second, contributions made at the outset have been earning income in the pension fund for longer and, therefore, presumably have made a greater contribution to the fund's ability to pay the pension. Given unlimited computer resources, these two factors can be measured with reasonable accuracy. The tax system, however, has an overriding need for administrative simplicity, and everyone does not have unlimited computer resources. Also, given the fact that there is a reasonable possibility that all these factors, if

99. Protocol, *supra* note 15, at art. 1(10) adding art. 23(2)(a)(ii)(*c*) to the Treaty, *supra* note 16. LR 7835003, P-H PRIV. LETTER RUL. ¶ 3012(78) (1978) provides that under United States tax law, Navy retirement pay is sourced at the country to which the taxpayer's services were attributable rather than being sourced at the payee's residence or in the payor's country. The same is true of United States Foreign Service pensions, LR 7819002, P-H PRIV. LETTER RUL. ¶ 1477(78) (1978). Both are pensions paid 100% by the employer. Rev. Ruls. 79-388-389, 1979-2 C.B. 270, 281, indicate that different rules apply where contributions are made to a fund, and the pension is a combination of contributions plus fund earnings.

pursued mathematically, will more or less cancel each other out, it seems more reasonable to construct a fraction the numerator of which is the number of years of pension contributions where the United States is the principal place of employment and the denominator is the total number of years of pension contributions.

French administrative instructions provide that where the activity is performed in the United States for more than half the year, the pension attributable to that year is exempt in France.[100] While the United States Internal Revenue Service apparently accepts this view,[101] it is inconsistent with recent rulings under United States law which would source the contributions where the work is performed but would source the earnings on the fund formed by the contributions where the fund is kept.[102]

This provision grants no relief where the individual's principal place of employment during a taxable year was outside the United States.[103] A person who worked principally in Belgium for a United States company, then retired in France, would receive no relief. That person would be fully subject to French tax, fully subject to United States tax, and only that portion of the pension that represents the repayment of contributions made for the time worked in Belgium (or other foreign countries) would be foreign-source income so as to lift the foreign tax credit limitation. The repayment of contributions attributable to business trips to the United States and payments from earnings on the pension fund, would both be income from United States sources.[104]

Alimony and Annuities

Two items of income which the Protocol does not mention are alimony and annuities received by a United States citizen residing in France. Under the Treaty, alimony and annuities are taxable only in the state of residence, but the United States retains the right to tax its citizens on them.[105] Both France and the United States would tax these items paid to a French resident-United States citizen.[106] Alimony or annuities paid from the

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100. 1980 Instruction, *supra* note 24, at II(2)(e).
101. Simonard, *supra* note 1, at 462 n.42.
102. Rev. Ruls. 79-388-389, 1979-2 C.B. 270, 281.
103. Simonard, *supra* note 1, at 463.
104. Rev. Ruls. 79-388-389, 1979-2 C.B. 270, 281.
105. Treaty, *supra* note 16, at arts. 19(2), 22(4)(a).
106. The problem may be further compounded by the fact that the United States and France do not tax annuities in the same way. In both countries, only part of each annuity payment is taxed. The United States prepares a fraction where the numerator equals the taxpayer's investment in the annuity and the denominator equals the total amount the taxpayer expects to receive. That fraction is multiplied by each year's annuity payments to determine how much of the pay-

United States would be considered by the United States to be United States-source income.[107] For this reason, the foreign tax credit limitation would not increase to support a foreign tax credit in the United States for French tax paid on alimony or annuities. Since neither alimony nor annuities are taxed at source under the Treaty, it would seem consistent with the Protocol's provisions relating to other income items to provide that, to the extent these items are taxed by France, they should be considered French-source.[108] No policy reason is apparent for excluding these items

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ments are exempt from tax on the theory of a return of capital. IRC § 72. France taxes only a percentage of a purchased life annuity, depending on the recipient's age when the annuity starts. That percentage is 70% if the recipient is less than 50; 50% if 50-59; 40% if 60-69; and 30% if more than 69. 1 DGI, PRECIS DE FISCALITE 223-24 (1980); CGI, *supra* note 3, at art. 158-6. Gratuitous annuities and alimony are taxed in their entirey, subject to a 10% deduction (with minimum and maximum amounts). An additional 20% of the amount taxable is allowed as a deduction. Thus, recipients of alimony and commercial annuities are taxed on 72% of the amount received. [100−10(10%)−18(20% of 90)]. 1 DGI, PRECIS DE FISCALITE 223 (1980); 1 F. LEFEBVRE, IMPOTS DIRECTS T1 §§ 2485-2506. FRANCE, *supra* note 12, at 481-82, 526-28. CGI, *supra* note 3, at art. 158-5. All this income is taxed as "TS" (*Traitements, salaires, pensions et retes viageres*).

107. Manning v. Commissoner, 80-1 USTC ¶ 9211 (1st Cir.) makes this clear. In Walter A. Howkins, 49 T.C. 689 (1968), a Rhode Island court ordered a resident alien to pay alimony to a nonresident alien. Payments came from a London bank account. It was held that the alimony was United States-source. While the United States court order was referred to, the major rationale analogized alimony to interest and so sourced it at the payor's residence.

108. It can be argued that this result is already accomplished by the literal language of the flush material following article 23(3)(b), which says, "The proportion of each item of income which is not considered as from sources within the United States under this subparagraph shall be considered as from sources within France." The argument continues that as no amount of alimony or annuities is considered from sources within the United States under that subparagraph, it must all be considered from French sources.

This argument cannot be defeated by invoking the savings clause of article 22(4) because subparagraph (b) thereof specifically exempts article 23 from its scope and because in case of conflict, article 23 would prevail over article 22 due to its later enactment. Nor can it be defeated by article 22(1)'s residuary taxation clause providing that: "any income from sources within a Contracting State to which the provisions of the present Convention are not expressly applicable shall be taxable by such Contracting State in accordance with its own law." Annuities and alimony are governed by article 19(2) of the Treaty, *supra* note 16, so that clause does not apply.

The real problem with the argument is that the text of article 23(3)(b) will not support the meaning attributed to it. Initially, it appears that the flush material applies only to article 23(3)(b), not to article 23(3)(a), for two reasons. First, the flush material specifically says it applies "under this subparagraph," and article 23(3)(a) is a different subparagraph. It would have to read "these subparagraphs" or "this paragraph."

Second, applying the flush material to subparagraph (a) makes little sense, since the flush material and subparagraph (b) refer to source of income for United from the benefits accorded to investment income. Nonetheless, neither alimony nor annuities receive specific double taxation relief in the Protocol. Both may present serious problems for the retiree with a purchased annuity or for a spouse of French origin who decides to return home after a divorce. France has recently announced agreement with the United States that permits full taxation of these items by France while the United States will consider them to be from French sources.[109]

Investment Income

United States-source investment income of a United States citizen who is also a French resident may be fully taxed by France on the basis of residence, and by the United States on the basis of citizenship. Since the income is from sources within the United States under United States law the foreign tax credit limitation is likely to preclude any foreign tax credit in the United States for the tax paid to France. The Protocol cures this double taxation by allocating taxing jurisdiction on an alternate basis according to the following three steps:

1. The United States may tax the income at source up to the rate it would be permitted to impose were the income going to a resident of France who is not a United States citizen—fifteen percent for dividends,[110] ten percent on interest (except interest received by a bank or government instrumentality),[111] five percent for noncopyright royalties, and exemption for the following: copyright royalties, capital gains, interest received by banks or government instrumentalities, and certain dependent and independent personal services income of entertainers and athletes.[112]

States foreign tax credit purposes, while subparagraph (a) deals with the tax credit given by France. Moreover, even if the flush material applies to both subparagraphs, each subparagraph is limited to income mentioned in article 23(2)(b), which is dividends, interest, royalties, capital gains and personal services income of artists and athletes. Textual improbability, however, has apparently given way to good policy. 1981 Note, *supra* note 1, at 7.

109. 1981 Note, *supra* note 1, at 7.

110. The uncertain tax treaty status of some items that are arguably dividends, such as capital gains distributions, payments from liquid assets funds or "return of capital" distributions should be noted. *Simonard, supra* note 1, at 471. For a description of the ordinary French tax on dividends, see Lazerow, *supra* note 4, at 691-93; Rosensweig, *U.S. Int'l Tax Treaty Policy with Respect to Foreign Imputation Systems of Corporate-Shareholder Taxation*, 13 N.Y.U. J. INT'L L. & POL. 729, 743-47, 753-66 (1981).

111. *See* text *infra* at notes 146-50.

112. Protocol, *supra* note 15, at art. 1(10) adding art. 23(3)(a) to the Treaty, *supra* note 16. That paragraph refers to article 23(2)(b), which in turn cross-references articles 9 (dividends), 10 (interest), 11 (royalties), 12 (capital gains), and, oddly enough, 22(4)(b) (artists and athletes). This is a strange group of bedfellows. Articles 9 through 11 are of one piece in that all items subject to them are

2. France then has an unlimited right to tax the income but must accord the taxpayer a credit for tax actually paid to the United States.[113] The United States tax on fifteen percent for div-

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taxable at a reduced rate or exempt, while items not subject to them are taxable under other articles. *See, e.g.*, Treaty, *supra* note 16, at art. 11(5). In the case of capital gains, if amounts are taxable at the source because the gains are effectively connected to a permanent establishment, article 12(3) specifically makes them taxable under article 6; if taxable at source because they are gains on real property, there is no cross-reference to article 5, but none is needed because of the specific inclusion therein of capital gains from realty. But in the cases where the exemption for capital gains does not apply because of a taxpayer's presence for at least 183 days, or because the gain is effectively connected to a fixed base, there is no reference to taxability under any other section. Thus, it is unclear whether these provisions apply since it is unclear whether the gain is taxable in the United States under article 12, as required by article 23(b)(2), or whether they are taxable in the United States because no provision of the treaty exempts them. As the former interpretation is most likely to avoid double taxation, it is to be preferred.

With regard to artists and athletes, article 22(4)(b) applies to all income of such persons residing in France, whether exempt from United States tax under articles 14 or 15 or not.

The above being the case, how is the numerator of the fraction to be computed? In a case where the item is exempt from United States tax at the source under articles 12, 14, or 15, the numerator is clearly zero so that all the income is from sources outside the United States. But, if the income is subject to United States tax, is it really "the rate of tax which the U.S. would be entitled to levy" under the Treaty, as the words of article 23(3)(b)(i) imply, which would be 100% as there is no Treaty limitation, or is it the rate which the United States would be entitled to levy under its domestic law, currently fixed at 30% on fixed or determinable, annual or periodic income, or on capital gains? IRC § 871. The 100% number would result in all such income being United States-source; use of the 30% rate might result in some part of the income being foreign-source, if the taxpayer's average rate of United States tax on gross income exceeds 30% or if the Treaty overrides IRC § 904(b)(2), a proposition doubtful both as a matter of policy and because article 23(1) says the credit is "subject to the limitations of the law of the United States (as it may be amended from time to time without changing the principle hereof)."

113. No credit will be given for income exempt from United States tax, such as interest on tax-exempt municipal bonds, because no tax is actually paid. Feldman, *Protocol to the U.S.-France Tax Treaty: Speedy Ratification is Sought*, [1979] COMMERCE IN FRANCE (Feb./Mar.); 1980 Instruction, *supra* note 24, at II(5). The Protocol, *supra* note 15, could be read to require credit even for interest not taxed in the United States. Article 23(2)(b) reads: "As regards income *taxable* in the United States under Articles 9, 10 . . . , France shall allow to a resident of France a tax credit corresponding to the *amount of tax levied* by the U.S. *under this convention* other than by citizenship." [Emphasis added]. The argument continues that a 10% tax may be levied under the convention on state and local bond interest; it is United States domestic law that does not do it. This argument would sit better textually if the phrase were "tax leviable" rather than "tax levied." Tax levied implies that the tax is actually paid. More important, a tax credit where no tax has been paid is a windfall rather than a relief of double taxation.

A second problem is whether the United States citizen French resident can obtain a tax credit from France for all the tax actually paid on interest to the United States. When such a person receives interest from a United States bank or savidends, ten percent for taxable interest, and five percent for noncopyright royalties will be credited against French tax to the extent of the French tax. In the case of certain capital gains, and income of artists and athletes that is taxable in the United States without limit, the entire amount of the United States tax will be allowed as a credit against the French tax up to the full French tax.[114]

3. The United States then has the unlimited right to tax the income, and the French tax actually paid (but not the French tax discharged by the credit mentioned in number two above) will be eligible to be credited against United States tax. To make this credit possible, the foreign tax credit limitation must be increased by increasing the amount of the taxpayer's income from sources outside the United States. This alchemy of changing United States-source income that has been taxed in France into French-source income occurs in the following way. Each category of income (*e.g.*, dividends) is treated separately. For each item of income, a fraction is constructed, the numerator of which is the rate at which that item could have been taxed by the United States were the taxpayer not a United States citizen (fifteen percent for dividends) and the denominator, which is the taxpayer's average rate of United States tax on gross income (United States income tax before credits divided by gross income). The item of income is then multiplied by the fraction to determine the amount of the income which is considered to be from United States sources. The remainder is from sources outside the United States.[115]

The result of this strange formula varies in a way quite unrelated to the taxpayer's foreign-source or United States-source in-

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ings and loan account, he is subject to a United States tax. A French citizen-French resident is not, because IRC §§ 861(a)(1)(A), (c), provides that such income received by a nonresident alien is not United States-source income and, therefore, not taxable under § 872(a)(1). Thus, France can argue that this income is only taxable in the United States because of the person's citizenship, so the credit for tax of up to 10% granted by article 23(2)(b) against French tax would not be allowable. Simonard, *supra* note 1, at 470-71. This is not the best interpretation of the Treaty, *supra* note 16. Article 10(6) provides: "Interest shall be deemed to be from sources within a Contracting State when the payor is that State itself, a political subdivision, a local authority, or a resident of that State." The bank paying the interest is certainly a United States resident. The purpose of article 23(2)(b) is to permit the source country to take the first taxation bite to the extent permitted by the Treaty. The fact that United States domestic law has exempted nonresident aliens from tax on this income as a matter of policy not required by the Treaty and by using the source rules instead of an outright exemption should not destroy the credit, as the credit conforms to the policy of the Treaty.

114. Protocol, *supra* note 15, at art. 1(10) adding art. 23(2)(b) to the Treaty, *supra* note 16.

115. *Id.*

come. It varies instead with the taxpayer's deductions. If the taxpayer has no deductions, the formula will permit a sufficient increase in the foreign tax credit limitation so that all the French tax paid may be credited.[116] In the more likely case where there are significant deductions (almost certain for French residents due to IRC section 913), not all United States tax will be absorbed by the credit for French taxes even if the rate of French tax is higher than the rate of United States tax.[117] This will induce the taxpayer to seek other foreign-source (but not French-source) income subject to foreign tax at a lower rate than the taxpayer's average rate of United States tax in order to generate excess foreign tax credit limitations. The easiest way to do this would be to buy stock in a company residing in a state that is a treaty partner and limited to fifteen percent tax on dividends; royalties income is also a possibility.[118] But how much simpler it would have been to have based the fraction on taxable income, or at least on adjusted gross income. Unfortunately, because the United States is the

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116. There might be some loss due to rounding off and the fact that the numbers do not exactly correspond to the purpose.

117. The source of this fraction is not clear. It can have radically different consequences depending on the composition of an individual's income because it uses gross income under IRC § 61, rather than adjusted gross income under IRC § 62, or taxable income under IRC § 63(b). Compare, for example, two taxpayers, each receiving $10,000 in dividends from United States corporations, each with personal deductions of $8,500, each with adjusted gross income of $50,000. Taxpayer *A*'s $50,000 is composed of the dividends plus salary of $40,000. Taxpayer *B*'s $50,000 is composed of the dividends, $490,000 in business income, and $450,000 of trade or business deductions under IRC § 162. Each has a United States tax liability of $13,392. The numerator for each taxpayer's fraction is 15. The denominator for taxpayer *A* is 27 ($13,392 tax/$50,000 gross income); the denominator for taxpayer *B* is 2.7 ($14,492 tax/$500,000 gross income). Taxpayer *B* thus receives no additional foreign-source income to support a foreign tax credit because his fraction is greater than 1, while taxpayer *A* finds that $4,444 of his $10,000 dividend is deemed to be from sources outside the United States. While one might think this a typographical error in the drafting because of the bizarre result, REPORT, *supra* note 9, at 17 provides an illustration showing that gross income is the intended term.

118. This works because the dividends that are taxed abroad at 15% may be subject to United States tax at a 50% rate. To illustrate, assume a taxpayer with $100,000 in dividends from the Netherlands taxed at 15% and $200,000 in income which the United States considers to be United States-source but which is taxed by Utopia at a 15% rate. The taxpayer's United States tax liability is $150,000; the taxpayer's total foreign tax is $45,000; the limitation on the taxpayer's foreign tax credit is $50,000($150,000 × $100,000/$300,000) so the taxpayer can credit the entire amount of foreign taxes paid. But without the Dutch dividends, the taxpayer could not have credited any of the Utopia taxes because the taxpayer lacks foreign source-income for United States tax purposes.

source country the fraction is neither based on taxable income nor on adjusted gross income.

The fraction is based neither on taxable income nor on adjusted gross income because their use could result in the United States, as source country, receiving less tax than the fifteen percent of the gross dividend (ten percent of the gross interest or five percent of gross noncopyright royalties) to which it is entitled.[119] This is true, whether the deductions are related to the income concerned or not, because the foreign tax credit limitation is not computed for each different income item (except interest).[120] This unavoidable conflict between the Treaty goals of avoiding double taxation and allocating tax between the two states has been resolved in favor of the latter. This problem will snare the inflexible or the uninformed but can be avoided by judicious investment to increase the foreign tax credit limitation as set forth above. For that reason, the Treaty should either have elected to avoid double taxation or to prevent evasion of the formula by separately computing the foreign tax credit limitation.

Other Income and Problems

Stock Options and Retirement Plans

France has agreed to the same timing as United States tax law on contributions to, and benefits from pension, profit-sharing and other retirement plans[121] as well as stock options.[122]

This promises to create some confusion, because the agreement applies only to the question of timing. This mutual provision says nothing about the source of this income, so the source should not be affected. Since this type of income will normally be income from the performance of personal services, its source should be the place where the personal services were performed. In the typical stock option, the individual receives the option after working for the company for a specified period. The employee can then exercise the option after a specified time if he is still employed by the company. Is the place where the services are performed the place where the employee worked during the period between the issuance of any previous options and the issuance of the options in question? Or does it also include the "waiting pe-

119. Conversation with Professor Joel Rabinovitz of U.C.L.A., currently Deputy International Tax Counsel.

120. *See* IRC § 904(d).

121. The timing on contributions was agreed to with the qualification, not commented upon in the legislative history, that such plans be required and "comparable to similar French arrangements." REPORT, *supra* note 9, at 18, 36, 57-58. 1980 Instruction, *supra* note 24, at 7-8.

122. REPORT, *supra* note 9, at 18, 36, 58.

riod"? The most practical solution would be to consider the options as payment for services rendered through their issuance and to disregard the waiting period in the interests of administrative convenience, because the waiting period will be accruing its own stock options.[123]

The matter becomes important because, if the compensation is received for personal services performed in the United States, France will not tax it.[124] A corporate employee who earns the option in the United States may be transferred to the French office during the option period, at the end of the option period, or after the expiration of the waiting period but before the exercise of the option. In the first case, France should only tax that portion of the income that relates to non-United States services. In neither of the latter two cases should France tax this income. It appears that France, however, may not agree with this interpretation.[125]

What is the French tax treatment of an option all of which will be taxed as capital gains by the United States and none of which will be taxed as ordinary income?[126] Does this mean that it will not be taxed by France? Read literally, the phrase only prevents the option from being considered compensation. It does not prohibit taxation under some other category. French law would not, however, normally tax this item except as compensation; so a French tax will await the sale of the shares bought with the option and then tax it at favorable capital gains rates. The note does

123. Simonard, *supra* note 1, at 461-62 n.37 seems to endorse an allocation based on time in the United States over total time, including both time before issuing the option and time after issuance but before exercise.

124. Treaty, *supra* note 16, at art. 14, 22(2)(a)(i) or (ii)(a).

125. *Compare* paragraph 3c of the Note, *supra* note 1, accompanying the Protocol, which says: "The advantages obtained from exercising a stock option will be considered as a remuneration for application of French tax when and to the extent that . . . [it is considered ordinary income for United States tax purposes]," *with* 1980 Instruction, *supra* note 24, at 7 which says that options "are considered a supplemental salary taxable in its entirety in France at the moment and to the extent . . . ." [author's translation].

The Protocol, *supra* note 15, makes it clear that no part that is ordinary income for United States tax purposes will be considered income from capital or a capital gain. Pension taxation would be simpler if this rule applied. *See* Rev. Rul. 79-388, 1979-2 C.B. 270, holding that the employer's pension contribution is personal service income, but any payment in excess thereof is investment income.

126. IRC § 422 (qualified options: last possible exercise date May 22, 1981) and 422A, added by § 251(a) of the Economic Recovery Tax Act of 1981, PUB. L. No. 97-34, § 251, 95 Stat. 256 (1981) (IRC 422a) (incentive options).

not refer to a tax on the sale of shares bought by exercising options but only to a tax triggered by the exercise of the option.

This is complicated by the fact that, in the absence of treaty, the French tax treatment of stock options issued by a non-French corporation is not clear. Special tax treatment delaying tax until exercise is established for certain options issued by French corporations.[127] While it can be argued that by implication other options are taxed when received, this might provide a better tax regime for options of foreign companies than for those of French companies. Although the tax would be paid earlier, the amount taxable would be much less. In view of the note, this seems an even less likely possibility as it would result in a tax on French employees of all United States corporations when the options are issued, while United States employees of the same corporation would not be taxed until exercise.

State and Local Taxes

State and local taxes on personal service and business income taxed in France will be allowed as a deduction for French tax purposes, clarifying a matter that was unclear under French tax law.[128]

Fringe Benefits

France promises to try to reach "a reasonable solution with United States residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States."[129] No more is said.[130] But the fact that determin-

127. CGI, *supra* note 3, arts. 80 *bis*, 163 *bis* C, 217 *quinquies*, 231-1 *bis*, and *bis* H. It is clear that the nontaxability of the option in the hands of the recipient if the stock is restricted and held for at least 4 years, and the exemption the company receives from the *taxes sur des salaires* (an excise tax on payroll), applies only to French companies qualifying under PUB. L. No. 70-1322 of December 31, 1970.

128. REPORT, *supra* note 9, at 18, 36, 58; *See* JURIS-CLASSEUR FISCAL 236-5 (15-16).

129. REPORT, *supra* note 9, at 18, 36, 58.

130. REPORT, *supra* note 9, at 58 suggests that the principle to be followed is whether a comparable benefit would be exempt under French law if accorded by a French company to a French taxpayer. 1980 Instruction, *supra* note 24, at 8 agrees. One assumes at first that these fringe benefits would be exempt under French domestic law and would not require a special diplomatic note, so something more must have been expected. But some tax benefits depend on the payor's residence or nationality. This provision suggests that the employer's nationality will not be determinative in deciding whether these benefits are taxable to these employees. The Instruction then suggests that each case will be decided on its own merits by the "Service de la Legislation fiscale, sous-direction E, bureau E-2," implying that a more extensive exoneration may be possible.

1981 Note, *supra* note 1, at 11 fixes three conditions for exemption: 1. The pension program must satisy United States law 2. It must call for mandatory contributions 3. The total amount of contributions must not exceed the maximum ing what is considered income by the United States is both unclear and subject to continuing legislative and regulatory activity may indicate the difficulties in implementing that promise.[131]

French Tax on Estimated Income

Exposure of United States citizens to tax as French residents also exposes them to certain Draconian tax measures. For example, when a resident's personal expenses exceed his or her income, article 180 of the CGI permits imposition of tax on the basis of the expenses.[132] The taxpayer may not prove that the amounts were received from the sale of a capital asset at no gain, from a loan or from a gift. No provision of the Treaty can be construed to prevent the imposition of this tax[133] and it would not be a creditable foreign tax for the United States citizen.[134] The tax imposed

fixed by French rules (currently 19% of salaries). Other rules apply to contributions not tied to salaries.

131. As to United States inclusion or exclusion of fringe benefits, the Treasury Department issued a discussion draft of proposed regulations on September 5, 1975, then withdrew it under fire in January, 1977. Factors that may have been used in the past in drawing the line that leans toward exclusion are minimal value, availability to all (or most) employees, designed to produce a more pleasant work situation, useful in performance of the employee's job, and non-negotiability. *See* CHOMMIE, *supra* note 51, at 57-59; M. CHIRELSTEIN, FEDERAL INCOME TAXATION 20 (1977); Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 HARV. L. REV. 1141 (1976); Popkin, *The Taxation of Employee Fringe Benefits*, 22 B.C. L. REV. 439 (1981). Of course, some fringe benefits are specifically excluded by statute. *E.g.*, IRC § 119 (meals and lodging).

132. CGI, *supra* note 3, art. 180 reads: "The income tax is specially assessed on any taxpayer whose personal, ostensible, and notorious expenses, increased by his income in kind, exceed his total exempt income and who either has not filed a return or whose declared income, after deductions allowed for expenses set forth in article 156, is lower than the total of the same expenses and income in kind. In regard to the taxpayer, the base for taxation is, in the absence of definite proof permitting the attribution to him of greater income, fixed at a sum equal to the amount of expenses plus income in kind, diminished by the amount of income exempt from tax under article 157, without permitting the taxpayer to reduce this assessment by in contending that he could have used capital or realized capital gains or that he could have received, periodically or otherwise, gifts from a third party or that certain of his income should normally be taxed on an estimated basis." [author's translation].

133. Treaty, *supra* note 16, at art. 23(4) reads: "A resident of a Contracting State who maintains one or several abodes in the territory of the other Contracting State shall not be subject in that other State to an income tax according to an imputed income based on the rental value of that or other abodes." This would only protect a United States resident, not a French resident-United States citizen.

134. Under Rev. Rul. 78-61, 1978-1 C.B. 221, it does not require realization and it is almost certain not to fall on net income. It can be alleged that this is an expenditure tax, rather than an income tax, thereby being a tax on a transaction.

by article 180 has been frequently criticized in the literature.[135] Though it has been referred to as a tax imposed infrequently and as a last resort, the volume of reported cases casts doubt on this assertion.[136]

The 1981 DGI note introduces a new uncertainty in this area by providing that "article 23-4 . . . does not prevent the provisions of article 209-A CGI [taxing foreign companies with realty in France at three times the rental value] from applying . . . to companies whose head offices are located in the United States."[137] The best interpretation of this statement is that it applies to companies formed outside the United States but having their head offices in the United States. That would be consistent with the Treaty. A company formed in the United States is a United States resident under the Treaty that cannot be taxed in France "according to an 'imputed' income based on the rental value of . . . abodes."[138] No justification for applying this tax on United States corporations appears.

Business Trips

Both countries follow the general rule that income from personal services has its source in the country where the services are performed. France, however, would fully tax the salary of a French resident on a business trip to the United States. Since this is United States-source income under United States law, double taxation occurred.[139] The Protocol provides that France will exempt from French tax income from personal services performed in the United States by a United States citizen, even if earned by a French resident.[140] While this relieves double taxation, it is opposite the solution adopted in the United States-Belgium Treaty, where income from business trips is sourced at the principal place of business.[141] Thus, three French residents may spend up to 183 days during a taxable year working in the United States, and the United States citizen will only be taxed in the United States, while the French citizen and the citizen of a

135. Verny, *La notion de depense pour l'application de l'article 180 du CGI*, 1980 Rev. Jur. Fisc. (Dupont) 3; Amselek, *La taxation d'office a l'impot sur le revenu ou sur un Janus de droit fiscal*, [1980] D. 31.

136. *E.g.*, CE 21 dec. 1979 #6,386, 1980 Rev. Jur. Fisc. (Dupont) #74, at 49; CE 1 fev. 1980, #14,137, 1980 Rev. Jur. Fisc. (Dupont) #183, at 103.

137. 1981 Note, *supra* note 1, at 7 [author's translation].

138. *See* Treaty, *supra* note 16, at arts. 2(1)(d)(i), 3(2), 23(4).

139. Herbert A. Filler, 74 T.C. 406 (1980).

140. Treaty, *supra* note 16, at art. 23(2)(a)(ii); 1980 Instruction, *supra* note 24, at II (3)(a).

141. Belgian Treaty, *supra* note 34, at arts. 14-15, 23(2).

third state will only be taxed in France.[142] The principle is established, the practicalities of allocation must be dealt with. The French instruction provides for allocation in accord with the realities of the situation; and, in default of other facts, an allocation based on time worked in the United States over 240 total working days is presumed.[143] Such an allocation might be normal for the United States; it is strange for France where the norm is to grant six weeks of paid vacation plus ten holidays each year. Thus, the normal French working year more nearly approximates 220 than 240 days. While the United States Internal Revenue Service has not spoken to the allocation principle, there is no reason to think that it would differ from the French. Different results may, however, be expected if the allocation system is differentially applied or because the total taxable compensation may be calculated differently under United States and French tax rules.[144] In such a case, the competent authority procedure may be invoked to try to reach agreement.[145]

OTHER INCOME OF BUSINESS INTEREST

Interest

The Treaty permits the source country to impose a ten percent or twelve percent tax on most interest.[146] The Protocol adds an exemption if the lender is a bank.[147] Normally, the United States seeks total exemption on interest but the Organization for Economic Cooperation and Development (OECD) recommends the ten percent rate.[148] It is not clear whether the ten percent recommendation results from a desire to equitably split the tax revenue between the two countries or from a feeling that interest payments between related persons are frequently disguised dividends, seeking both the deductions and the reduced rate

142. *Id.* at arts. 15, 23(2)(a)(ii).

143. 1980 Instruction, *supra* note 24, at II(3)(a).

144. Simonard, *supra* note 1, at 461.

145. Treaty, *supra* note 16, at art. 25(2)(c).

146. *Id.* at art. 10(2), (3). *See* LAZEROW, *supra* note 16, at 54.

147. Protocol, *supra* note 15, at art. 1(9) adding art. 10(9) to the Treaty, *supra* note 16.

148. ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT, Draft Double Taxation Convention on Income and Capital (1963), TAX TREATIES (P-H) ¶ 1081 [hereinafter cited as the OECD Draft].

appropriate to interest.[149] The total exemption for banks indicates that the French feeling was the latter. France must now believe that a bank as a lender is unlikely to juggle the source or the nature of the payment since banks are in the lending business. It is not clear why the same consideration was not shown to others in the lending business, such as insurance companies.

The legislative history of the provision is disingenuous. It explains the source of the provision as confusion over whether the *Banque Française du Commerce Exterieur*, which is similar to the United States Export-Import Bank, is a government instrumentality entitled to exemption from United States tax on United States-source interest income.[150] That problem could easily have been resolved by an agreement between the taxing authorities, by a revenue ruling or by a limited provision applicable only to that bank. It appears that France and the United States were searching for an opportunity to broaden the exemption, probably as a result of pressure from banks. Nonetheless, the liberalization is sufficiently worrisome to insert a comment that a non-bank cannot launder its loan by passing it through a bank to receive the exemption.[151] Since large quantities of bank interest from abroad will be effectively connected with a permanent establishment located there, which remains taxable at source, the revenue impact of this provision may not be too severe.

Shipping and Aircraft

Under the Treaty, income derived by a resident of one country from the operation of shipping or aircraft in international traffic is exempt from tax in the other state if the vessel is registered in the residence state. The Protocol eliminates the registration requirement.[152] This change will permit the many United States-owned vessels registered in Liberia and elsewhere to receive Treaty benefits, simplifying their tax and accounting problems.

It will also permit French shipping and airline companies to lease vessels from United States owners who have received the investment credit and still qualify for the Treaty exemption.[153] This was effectively prevented under the old Treaty because, if

149. See the discussion of interest and royalties on this point at Lazerow, *supra* note 4, at 699-700.

150. REPORT, *supra* note 9, at 9, 47; J.O. Déb. AN 6 June 1979, at 4696.

151. REPORT, *supra* note 9, at 9.

152. Protocol, *supra* note 15, at art. 1(4) replacing art. 7 of the treaty, *supra* note 16; REPORT, *supra* note 9, at 7-8, 44-46. *See* Lazerow *French* 664-65 and LAZEROW OECD 25-27.

153. The French legislative history pinpoints the lease by Air France of Boeing 747s. J.O. Déb. AN 6 June 1979, at 4696.

the ship were registered in the United States and operated by a French resident, there was no Treaty exemption from United States tax. If the ship were registered in France, there could be no investment credit.[154]

This explanation seems disingenuous. First, there are other ways of accomplishing the same objective without granting benefits to all residents. One would be a treaty provision setting forth the specific circumstances under which the investment credit would be granted. Second, the United States Treasury Department's technical memorandum demonstrates the Treasury Department's unhappiness with granting both the investment credit and a tax exemption by saying that the United States will seek legislation denying the investment credit in those circumstances. The memo cites as an analogy IRC section 48(a)(4), a provision that denies the investment credit where property is leased to a tax-exempt organization. That case can be distinguished on the grounds that the tax-exempt organization is not subject to tax at all, whereas the French shipping company is subject to income tax in France. Putting that to one side, one must conclude that if the Treasury Department is opposed to the expressed purpose for the provision and inserts it nonetheless,[155] there is a second purpose—which is to harmonize United States treaties with those of its trading partners by eliminating the registry requirement, without perhaps incurring too much union wrath. Subsequent treaties have also eliminated the registration requirement, confirming this suspicion.[156]

A second major change was apparently felt necessary when the registry requirement was dropped. The exemption is available to a corporation of one of the countries only if more than fifty percent of its capital (stock plus long-term debt) is held by that country, its residents or residents of another country with whom it has a shipping and aircraft exemption agreement. The percentage is reduced to twenty percent if more than fifty percent of the company's stock is listed and regularly traded on a recognized se-

154. IRC § 48(a)(2)(B)(i), (iii).

155. REPORT, *supra* note 9, at 44-45.

156. Proposed Treaty between the United States and Egypt of August 24, 1980, TAX TREATIES (P-H) ¶ 34,101; Proposed Treaty between the United States and Bangladesh of October 6, 1980, TAX TREATIES (P-H) ¶ 18,101; Protocol to the Proposed Treaty between the United States and Norway of September 19, 1980, TAX TREATIES (P-H) ¶ 69,069 at art. III; United States Model, *supra* note 1, at art. 8(1).

curities exchange.[157] This certainly avoids treaty shopping by close corporations owned by citizens of countries with whom France and the United States do not have shipping agreements. The number of such states must be small. France has more than sixty tax treaties, while the United States has half that many. To this total the many executive agreements providing reciprocal exemption for shipping and aircraft profits must be added.

The requirement that more than fifty percent of a corporation's stock and long-term debt be owned by someone who can benefit from the Treaty may be easy to apply by consulting the corporation's books. It is likely, however, that any corporate shareholder or creditor will also be "pierced"; otherwise, the fifty percent requirement could be avoided by interposing a French corporate shareholder or creditor between the real party in interest and the shipping corporation. Thus, it appears that the shipping corporation must demand a list of shareholders and creditors from each of its corporate shareholders and long-term creditors.

Further, one wonders why only shipping and aircraft requires that the corporate veil be pierced. Surely the danger of establishing a corporation in a country solely to obtain treaty benefits is at least as great with investment income as with shipping. The fact that the subsequently negotiated treaties[158] contain no such limitation in their liberalized articles leads one to search the French literature for a source for this limitation. One finds the origins of this requirement for fifty percent ownership by nationals in the requirements for French registration of ships established by article 126, *Code Special des Douanes du 8 décembre 1948*, and for aircraft by French air law. A ship owned by a partnership may be French registered only if at least half the value of its partnership shares are owned by French citizens, while to register an aircraft all the partners must be French citizens. Where a corporation is the owner of a ship or aircraft, the president must be a French citizen. Moreover, at least a majority of a corporation's administrators owning a ship or all of a corporation's administrators owning aircraft must be French citizens as well.[159]

The French Treaty is modified by the Protocol in several re-

157. Protocol, *supra* note 15, at art. 1(4) adding art. 7(3) to the Treaty, *supra* note 16. These prophylactic provisions are made even harsher by REPORT, *supra* note 9, at 8, providing that where a shareholder is a resident of a state with whom a treaty exists requiring registry, the vessel must be registered either in France or in that country. This cuts against the purpose stated for the change.

158. *See* note 150 *supra*.

159. Chretien, *Une espece originale de traités fiscaux: les conventions internationales sur la double imposition des entreprises maritimes ou aeriennes*, 1951 REVUE DE SCIENCE & LEGIS. FIN. 513, 715, at 519-20.

spects to bring it abreast of other United States treaties in defining the income exempted.[160] It is specified that gains from the sale of ships or aircraft are taxable only in the residence state, as well as income from full or bareboat charters and incidental container rentals.[161] But the container provision is narrower than the United States prefers as it requires not only that the containers be used in international traffic (which is specifically but unexceptionally defined in the Protocol)[162] but also that the container income be incidental to other profits from international traffic. It appears that the French willingness to exempt United States lessors is somewhat limited.

Ship and Aircraft Crews

The article confining the taxation of ship and aircraft crews to the residence country of the operator has been changed to eliminate the registry requirement.[163] While a liberal interpretation of this provision will eliminate all problems, a redraft of the article could eliminate interpretation problems based on the phrasing of the exemption as limited to the "regular complement" and tying the crew's exemption to that of the vessel. The root problem is that while the article speaks of both ships and aircraft, it is drafted with the situation of ships in mind, and does not accord well with the way aircraft are in fact operated.

The exemption is available to the crew if "*the* income from *the* operation of the ship or aircraft is exempt."[164] While this seems to imply that all income of that vessel must be exempt, the senate report states that, if the individual works at least partly in international traffic and some of the vessel's income is exempt, then the crew member's income is also exempt.[165] This requires a strained interpretation of the words of the provision. It might be redrafted to grant the exemption on the terms set forth in the

160. *See* Rev. Rul. 70-263, 1970-1 C.B. 148, exempting interest paid on working capital under IRC § 883. The same rule probably applies to the Treaty.

161. Protocol, *supra* note 15, at art. 1(4) adding art. 7(4) to the Treaty, *supra* note 16. *See* LAZEROW, *supra* note 16, at 26-27.

162. Protocol, *supra* note 15, at art. 1(2)(2) amending art. 1(e) of the Treaty, *supra* note 16. The activities specified in Rev. Rul. 76-568, 1976-2 C.B. would be tax free because they are incidental to profit from international transport.

163. Protocol, *supra* note 15, at art. 1(7) amending art. 15(3) of the Treaty, *supra* note 16.

164. *Id.* REPORT, *supra* note 9, at 9 [emphasis added].

165. REPORT, *supra* note 9, at 9-10.

senate report.[166]

A second problem is the requirement that the individual be a regular member of the crew of a particular ship or aircraft. While ships have regular crews, aircraft crews are detached from a particular plane. A crew may fly Paris to New York on aircraft *A* today, then New York to Los Angeles on aircraft *B* tomorrow, and three days later return to Paris from Los Angeles on aircraft *C*. The crew may be aboard none of these aircraft more than ten percent of its total flying time. Are they regular members of its crew? If so, they are regular members of the crew of all aircraft they fly regularly. Suppose aircraft *B* never leaves the United States. Is the crew not exempt from United States tax on their salaries for the time on aircraft *B* because aircraft *B* is not in international traffic? Surely that was not the intention of the provision, but that is how it reads.

Why require that a person be a member of the regular complement of the aircraft? Surely the pilot who regularly flies Paris-Nice, but is detached to fly Paris-New York for one day due to the illness of the regular pilot is more deserving of exemption from United States tax than is the regular pilot. If on the other hand, one interprets "regular complement" to mean that the position the person fills is regularly filled on that craft, rather than that the taxpayer is the person who regularly fills it, then the regular complement requirement appears destined to tax any person who is on the flight on an experimental basis, such as a magician sent to entertain the passengers because no movie is available. But that person should also be entitled to the exemption, given the briefness of his United States contact. The "regular complement" condition is not drawn from the OECD Draft.[167] It seems designed to prevent harbor pilots from claiming exemption in their home ports under this article. The provision could be redrafted to be more specific.

Excise Tax on Insurance Policies

Henceforth, the Treaty will cover the United States excise tax on insurance policies issued by foreign insurers. In order to prevent abuse, the exemption is limited to situations where the risk is not reinsured with a person not entitled to the exemption.[168] The result is that, to the extent that the foreign insurance com-

166. United States Model, *supra* note 1, at 15(3) has done so.

167. OECD Draft, *supra* note 148, at art. 15(3) exempts income from "an employment exercised aboard a ship or aircraft. . . ."

168. Protocol, *supra* note 15, at art. 1(1) amending art. 1(1)(a) of the Treaty, *supra* note 16. IRC §§ 4371-4373.

pany does not have income attributable to a permanent establishment in the United States, it will be exempt from this excise tax. Where it does have a United States permanent establishment, it is apparently not subject to the tax by the terms of United States law.[169]

Source of Royalties

The Protocol makes no change in the source rules for royalties, a provision which has become a textbook example of problems of official versions of a document in two languages.

The English version reads: "Royalties paid for the use of . . . property . . . in a State shall be treated as income from sources within that State." In French, the locational clause has been moved forward so the sentence reads: "Royalties paid in a State for the use of . . . property . . . are treated as income having its source in that State."[170] Movement of the prepositional phrase means that the English version sources the income at the place of use, while the French version uses the place of payment. The Protocol would have been a good opportunity to clarify this ambiguity.

One explanation for the failure to change the provision may be general satisfaction with the *status quo*. Presumably the French and United States Treasuries are each happy with its version (even though it permits a United States taxpayer to reduce French tax by careful planning). The United States taxpayer using industrial property in France arranges for payment of royalties in the United States. The French government exempts these royalties from income tax because it considers them to be from United States sources. The United States taxpayer increases his foreign tax credit limitation because for United States tax purposes this is French-source income.[171] The French taxpayer using United States industrial property arranges for royalty payments in the United States and is subject to five percent United States tax. That person then takes advantage of the Treaty to credit the five percent United States tax against French tax.[172] Thus, careful

169. REPORT, *supra* note 9, at 4-6.
170. Treaty, *supra* note 16, at art. 11(6). TIXIER, GEST & KEROGUES, *supra* note 9, at 173-420.
171. IRC §§ 861(a)(4), 862(a)(4).
172. Protocol, *supra* note 15, at art. 23(2)(b).

planning assures no double taxation for the French taxpayer, and a windfall for the United States taxpayer.

Trust Income

The trust is a peculiarly Anglo-Saxon institution. As such, it often perplexes those trained in other legal systems and sometimes causes them to suspect it as an evil institution to be subjected to extreme suspicion. For many years, France taxed distributions from a trust to its beneficiaries as dividends.[173]

The debate on this Treaty has focused French attention on United States taxation of trusts,[174] and the French have decided that French tax should accord with United States tax. Thus, the following principles will apply. First, distributions of trust income will be classified as though the beneficiary had earned the underlying income *pro rata*. Thus, if trust income for the year of a simple trust is twenty percent interest, thirty percent royalties, and fifty percent dividends, the beneficiary's income distribution will be considered twenty percent interest, thirty percent royalties, and fifty percent dividends. Second, simple trusts will not be taxed, and their income will be taxed to the beneficiary (apparently whether actually distributed or not). Third, complex trusts will not be taxed by France, and their distributions will be taxed to the beneficiaries. The beneficiaries residing in France will be entitled to an appropriate tax credit for the tax actually paid by the beneficiary to the United States under Treaty rules (the percentage depends on the type of income), but no credit will be available for any tax previously paid by the trust on the accumulation of income in earlier years. Finally, France implies that it will treat grantor-taxable trusts as the United States would: tax the income to the grantor rather than to the beneficiaries.[175]

The new system significantly improves the old French system. As most cases are likely to involve complex trusts making current distributions of nearly all income, most double taxation will be relieved. There may be, however, significant double taxation remaining where a complex trust accumulates income, because in that case the French revert to their view that the trust is a separate entity and refuse to credit against French taxes the tax paid by the trust in the year in which the income is earned. Thus, the income will be subject to: 1) United States tax on the trust when earned by the trust; 2) United States tax on the beneficiary when

173. Lazerow, *supra* note 4, at 656.
174. J.O. Deb. Sen. 27 juin 1979 at 2396-400 [1979].
175. 1981 Note, *supra* note 1, at 4-6.

distributed; and 3) French tax on the beneficiary when distributed, although a credit will be given for number two.

CONCLUSIONS

The Protocol is extremely important. It confirms trends in recent United States tax treaty policy to cover the excise tax on insurance premiums, to remove the registry requirement for shipping and aircraft, and to reduce interest taxation at the source of the income as much as possible.

The Protocol is important to those faced with the double taxation problems posed by being both French residents and United States citizens. It is also important to United States citizens residing in other countries as a precedent. While most of the countries of the developed world have made arrangements so that United States citizens will not be treated by those countries as residents, that largesse surely will not continue indefinitely. Sooner or later, each country will demand an appropriate share of taxes from United States citizens residing in their countries. When that happens, the United States-France Protocol will be the existing model to be followed to relieve possible problems of double taxation.[176] It is perfectly appropriate as a model. Even more than most tax treaties, it combines the relief of double taxation in an effective manner with an equitable division of revenue between the countries involved. While there are minor technical problems of interaction between the two nations' tax laws, minor drafting infelicities, and a system of relief for alimony and annuities worked out administratively which should be in the Treaty, the Protocol removes most of the major, unjustifiable tax impediments to the free movement of citizens from one country to the other.

The Treaty as amended is not perfect. No treaty can take a taxpayer subject to two different, complex tax systems and place that taxpayer in the situation of a person subject to only one system. Each system has its relief mechanisms that differ from its neighbor. Even a treaty like the United States-France Treaty will not equalize the two-country taxpayer with the one-country taxpayer because the tax shelters provided by the two countries'

176. It has been suggested that some of these approaches be used with Canada and Denmark. Burge, *Status of Tax Treaty Negotiations*, 34 BULL. INT'L FISCAL DOC. 55, 57 (1980).

laws do not match. For example, France and the United States both permit the tax-free receipt of certain interest income.[177] But the interest that is tax-free in France is taxable in the United States and vice-versa. Likewise, the real estate investment that shelters business income in the United States holds no French tax benefits.[178]

The fact that every taxpayer is not fully relieved of double taxation is regrettable in light of that best of all possible worlds where Candide wished to live. Unlike Candide's wishful world, in this world double taxation is unavoidable. If the Treaty relieves double taxation for most taxpayers, which means for the typical taxpayer, that is a great step forward. Maître Azard would have applauded the accomplishment, then he would have suggested that we try to improve on it at the next negotiation.

177. *Compare* IRC § 103, exempting interest on obligations of state and local governments, *with* CGI, *supra* note 3, at art. 157-2° *bis*, -3°, -7°, -8° *bis*, -9° *bis*, -9° *ter*, -14°, -15°, exempting interest on certain savings accounts. 1 DGI, PRECIS DE FISCALITE 280-81 (1980).

178. No French tax benefits exist because losses from one category of income, real property in this case, generally cannot be offset against income from other categories such as salaries, business income, or non-commercial income, under the French income tax system.