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INCOME TAX CONVENTION WITH THE FRENCH REPUBLIC

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Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 103–32, 103rd Congress, 2d Session]

The Committee on Foreign Relations, to which was referred the Convention between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, signed at Paris on August 31, 1994, together with two related exchanges of notes, having considered the same, reports favorably thereon, without amendment, and recommends that the Senate give its advice and consent to ratification thereof, subject to one declaration as set forth in this report and accompanying resolution of ratification.

I. PURPOSE

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

II. BACKGROUND

The proposed treaty was signed on August 31, 1994. The proposed treaty was amplified by diplomatic notes signed the same day, and by additional notes signed on December 19, 1994 and December 20, 1994. The proposed treaty replaces the existing income

99–119

tax treaty between the two countries that was signed in 1967 and modified by protocols signed in 1970, 1978, 1984, and 1988.

The proposed treaty was transmitted to the Senate for advice and consent to its ratification on September 19, 1994 (see Treaty Doc. 103–32). The Committee on Foreign Relations held a public hearing on the proposed treaty on June 13, 1995.

III. SUMMARY

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty [1] (the "U.S. model"), and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains some deviations from these documents. Among other modifications, the proposed treaty includes a number of revisions to accommodate aspects of the Tax Reform Act of 1986.

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

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

The proposed treaty contains a "saving clause" similar to that contained in other U.S. tax treaties (Article 29(2)). Under this provision, the United States generally retains the right to tax its citizens and residents as if the treaty had not come into effect. In ad-

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

dition, the proposed treaty contains the standard provision that it does not apply to deny a taxpayer any benefits that person is entitled to under the domestic law of the country or under any other agreement between the two countries (Article 29(1)); that is, the treaty applies to the benefit of taxpayers.

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

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

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

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

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

(4) A U.S. citizen who is not also a U.S. resident (i.e., does not have a substantial presence, permanent home, or habitual abode in the United States) generally is not covered by the proposed treaty

(Article 4).[2] The U.S. model does cover such U.S. citizens. The United States rarely has been able to negotiate coverage for nonresident citizens, however.

(5) For purposes of qualifying for benefits under the proposed treaty, the term "resident of a Contracting State" specifically includes the governments of the two treaty countries, including their political subdivisions and local authorities, and any agencies or instrumentalities of those national or subnational governmental bodies. The term also covers a pension trust and any other organization established in the treaty country and maintained exclusively to administer or provide retirement or employee benefits that is established or sponsored by a person that is a treaty-country resident, and any not-for-profit organization established and maintained in the treaty country, provided that applicable local laws limit the use of the organization's assets, both currently and upon the dissolution or liquidation of such organization, to the accomplishment of the purposes that serve as the basis for such organization's exemption from income tax.

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

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

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

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

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

the basis of the imputed rental value of housing owned in the taxing country by an individual resident of the other treaty country (Article 29(5)). Only France currently imposes tax on such a basis.

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

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

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

(13) Like the present treaty and some other existing U.S. income tax treaties, Article 8 of the proposed treaty does not provide protection from source country taxation of income from leases of containers used in international traffic to the same extent as the U.S. model treaty, which exempts such income from source country tax as income from the operation of ships or aircraft in international traffic. For example, the model provides for exemption from tax in the source country for a container lessor (such as a financial institution or a leasing company) that does not also operate ships or aircraft in international traffic, but that leases containers to others for use in international traffic. Under the proposed treaty, the exemption for shipping profits does not apply to profits from container leasing unless those leasing activities are "accessory" or incidental to international shipping activities of the lessor. Such profits are treated as business profits under the proposed treaty, and thus exempt from tax in the source country unless attributable to a permanent establishment in that country.[3]

(14) Similar to the OECD model treaty, the article on associated enterprises (Article 9) of the proposed treaty omits the provision

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

found in the U.S. model treaty and in most other U.S. treaties, which clarifies that neither treaty country is precluded from (or limited in) the use of any domestic law which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of one of the treaty countries, owned or controlled directly or indirectly by the same interests, where necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons. However, the Treasury Department Explanation of the Convention Between the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Paris on August 31, 1994, May 1995 (the "Technical Explanation") states that the omitted language serves merely as a clarification, and that the proposed treaty is intended to fully preserve the rights of each country to apply its internal laws relating to adjustments between related parties.

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

(16) Generally, the proposed treaty, the U.S. model, and the OECD model all share a common definition of the term "dividends."[4] The proposed treaty further defines this term, however, to include income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the local law on the treaty country in which the income arises. This clarifies that each country applies its domestic law, for example, in differentiating dividends from interest.

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

(18) The proposed treaty, like the present treaty, allows U.S. shareholders to receive the benefit of all or a portion of the dividend tax credit (*avoir fiscal*) that French resident shareholders re-

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

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

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

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

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

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

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

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

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

(20) Under Article 11 of the proposed treaty, like the present treaty and the U.S. model treaty, interest generally is exempt from source-country taxation. However, interest that is determined by reference to the profits of the issuer (or one of its associated enterprises) is subject to source-country taxation at a maximum rate of 15 percent. In addition, no exemption or reduction of U.S. withholding tax is granted under the proposed treaty to a French resident that is a holder of a residual interest in a U.S. real estate mortgage investment conduit (a "REMIC") with respect to any excess inclusion.

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

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

(22) Although not found in the OECD model, the U.S. model, or many other U.S. treaties, Article 12(6) of the proposed treaty contains a special provision for determining the source of royalties. The special sourcing provision includes three separate rules. First, if the royalty is paid by a resident of the United States or France, the royalty is treated as arising in that country. Second, if the royalty is paid by a person, whether or not a resident of the United States or France, that has a permanent establishment or fixed base in one of the countries in connection with which the liability to pay the royalty arose, and if the royalty is actually borne (i.e., is deducted in computing taxable income) by that permanent establishment or fixed base, then the royalty is deemed to arise in the country in which the permanent establishment or fixed base is located. Third, notwithstanding the first and second rules, a royalty paid for the use of, or the right to use, property in the United States or France is deemed to arise in that country. The Committee understands that this provision applies both for purposes of determin-

ing whether royalties are taxable in the source country, and in determining the source of royalties for purposes of computing the foreign tax credit under the article on relief from double taxation (Article 24). This dual application of the special sourcing provision avoids a potential mis-match between jurisdiction to tax and obligation to relieve double taxation.

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

(23) Both the U.S. model treaty and the proposed treaty (Article 13) provide for source-country taxation of capital gains from the disposition of property used in the business of a permanent establishment in the source country. Like most recent U.S. tax treaties, the proposed treaty also provides for source-country taxation of such gains where the payments are received after the permanent establishment has ceased to exist. In addition, the proposed treaty provides that in a case where the laws of one treaty country tax the removal of such property from that country as a deemed disposition of the property, that country is permitted to tax the gain that accrues up to the time of removal, and the other country is permitted to tax the gain that accrues after the time of removal. The Technical Explanation indicates that such divided tax jurisdiction is exclusive; the residence country is not permitted to tax gain accruing prior to removal, and the source country is not permitted to tax gain accruing subsequent to removal.

The Committee understands that this provision represents a combination of the French custom of taxing accrued, but unrealized gains at the time the asset is removed from France, with the U.S. rules that generally permit the United States to tax the realization of gains from the disposition of property that formerly was part of a U.S. business. This rule of the proposed treaty is not subject to the saving clause.[5]

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

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

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

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

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

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

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

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

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

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

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

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

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

(33) Unlike the U.S. model treaty, the proposed treaty makes no special provision for the treatment of alimony or child-support payments. Taking into account the "other income" article, the result in

the case of alimony is generally similar to that under the model; the result in the case of child support may not be.

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

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

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

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

(38) Under Article 23 of the proposed treaty, as under the U.S. and OECD model treaties, capital may be taxed by the country in which located if it is real property owned by a resident of either country, or if it is personal property forming part of the business property of a permanent establishment or fixed base maintained by a resident of the other country. The owner's country of residence may also tax that property. The right to tax ships, aircraft, and related movable property (including containers) operated in international traffic belongs solely to the country in which the owner resides. The proposed treaty also allows a country to tax the capital

represented by a substantial interest in a company that is a resident of that country. All other capital of a resident of a treaty country is taxable only in the residence country. The proposed treaty provides a special rule under which France may not impose its wealth tax on the foreign property of a U.S. citizen (not also a French citizen) resident in France for the first five years of French residency.

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

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

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

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

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

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

(42) The mutual agreement article of the proposed treaty also specifically permits competent authority agreements that cover fu-

ture as well as past years. This clarifies that the French government may enter into bilateral advance pricing agreements (APAs).

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

(44) The proposed treaty, in its exchange of information article (Article 27), provides authorization for representatives of one treaty country to enter the other treaty country for the purpose of interviewing taxpayers and examining books and records, but only with the consent of the affected taxpayers and of the competent authority of the second treaty country. The effective date of this provision is delayed until the two countries have agreed that it will take effect, to be evidenced by a future exchange of diplomatic notes.

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

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

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

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

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty will enter into force upon the exchange of instruments of ratification. The proposed treaty provisions with respect to taxes collected by withholding and the Federal insurance excise tax generally apply to amounts paid on or after the first day of the second month following the date on which the treaty enters into force. With respect to other taxes, the proposed treaty will take effect for taxable periods beginning on or after the first day of January following the date on which the treaty enters into force. As discussed above, the reduced *avoir fiscal* and French withholding taxes on royalties will take effect for distributions and payments made after December 31, 1990.

B. TERMINATION

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it at any time after five years from the date of its entry into force, by giving at least six months prior written notice through diplomatic channels.

With respect to taxes withheld at source, a termination will be effective for amounts paid or credited on or after the first of January following the expiration of the six-month period. With respect to other taxes, a termination is to be effective for taxable years beginning on or after the first of January following the expiration of the six-month period.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed French Republic treaty, and on other proposed tax treaties and protocols, on June 13, 1995. The hearing was chaired by Senator Thompson. The Committee considered the proposed French Republic treaty on July 11, 1995, and ordered the proposed treaty favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to the ratification of the proposed treaty.

VI. Committee Comments

The Committee on Foreign Relations approved the proposed treaty with a declaration that certain interest payments made to French subsidiaries that are controlled foreign corporations (as defined in Code sec. 957) should be automatically exempt from U.S. tax to the extent the payments are taxable to the payor under the subpart F provisions of the Internal Revenue Code. On balance, the Committee believes that this treaty is in the interest of the United States and urges that the Senate act promptly to give its advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed treaty, and believes that the following comments may be useful to U.S. Treasury officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. ANTI-ABUSE PROVISIONS

General rule

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

The proposed treaty, like a number of U.S. income tax treaties, generally limits the class of treaty country residents eligible for benefits. Benefits are bestowed only upon those treaty country residents with a sufficient additional nexus, beyond simple residence, to the treaty country. In its outlines, the anti-treaty-shopping provision of the proposed treaty is somewhat similar to the anti-treaty-shopping provision in the branch tax provisions of the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties. In its details, on the other hand, the proposed treaty resembles only the 1993 U.S. treaty with the Netherlands, which was in many ways unprecedented. The degree of detail included in this provision and in the Netherlands provision, relative to other treaties, is notable in itself. First, the proliferation of detail may reflect, in part, a diminution in the scope afforded the Internal Revenue Service ("IRS") and the courts in the anti-treaty-shopping provisions of most previous U.S. treaties to resolve interpretive issues adversely to a person attempting to claim the benefits of the treaty; this diminution represents a bilateral commitment, not alterable by developing internal U.S. tax policies, rules, and procedures, unless enacted as legislation that would override the treaty. (To the same extent as is provided under other treaties, the IRS generally is not limited under the proposed treaty in its discretion to *allow* treaty benefits under the anti-treaty shopping rules.) In addition, the detail in the proposed treaty represents added guidance for taxpayers that may be absent under most other treaties, although the negotiators of most other U.S. treaties have chosen to forego such additional guidance in favor of somewhat simpler and more flexible provisions. In general, the provisions of the anti-treaty shopping article of the proposed treaty tend to be at least somewhat more lenient than the comparable rules in the U.S. regulations under the branch tax, and other U.S. treaties, although every existing anti-treaty-shopping standard potentially may be satisfied through the exercise of more or less broad discretion of the Secretary of the Treasury. The proposed treaty is also one of the first to provide mechanical rules under which so-called "derivative benefits" are afforded.[6] Under these rules, a French entity is afforded benefits based in part on its ultimate ownership by a third-country resident who would be entitled to U.S. treaty benefits under an existing treaty between the United States and the third country.

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

The base erosion requirement in recent treaties allows benefits to be denied if 50 percent or more of the resident's gross income is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to certain classes of persons not entitled to treaty benefits. A similar test applies under the branch tax. The "base reduction" test in the proposed treaty modifies this test in several respects. First, the test does not take into account income used to meet an arm's-length liability, if the liability is incurred for (1) tangible property in the ordinary course of business, or (2) services performed in the payor's residence country. In some cases, payments to residents of EU member countries are also afforded favorable treatment. Thus, the base-reduction test in the proposed treaty, like the similar test in the U.S.-Netherlands treaty, is different, and may be more favorable to taxpayers, than most of its predecessors.

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

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

The proposed treaty is similar to other U.S. treaties and the branch tax rules in affording treaty benefits to certain publicly traded companies. The treaty definition of "publicly traded" is explained in much greater detail in the proposed treaty than in most existing U.S. treaties. Again as in the case of the active business test, in some cases this elaboration mirrors the branch tax regulations, but is less rigorous. Also, like the branch tax rules, the proposed treaty allows benefits to be afforded to the wholly-owned subsidiary of a publicly traded company. Unlike most predecessors, the proposed treaty provides that benefits must be afforded to certain joint ventures of publicly traded companies, including in some cases joint ventures involving publicly traded companies resident in EU member countries other than France. Moreover, unlike the corresponding provision of the U.S.-Netherlands tax treaty, upon which this joint-venture provision is modeled, the proposed treaty does not require that if benefits are to be afforded a company resident in a treaty country on the basis of public trading in the stock of the company's shareholder or shareholders, the company seeking treaty benefits also meet an anti-conduit test that measures base erosion.[7] Thus, under the proposed treaty, a joint venture of two publicly traded companies could qualify for treaty benefits even if most of its gross income avoids taxation in France through base erosion. However, there may be significantly less potential for tax

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

avoidance through base erosion under the tax laws of France than in the Netherlands.

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

Like other treaties and the branch tax rules, the proposed treaty gives the competent authority of the source country the power to allow benefits where the anti-treaty-shopping tests are not met. The proposed treaty states that benefits are to be allowed in a case where the competent authority of the country allowing the benefits determines that obtaining treaty benefits was not one of the principal purposes in establishing, acquiring, or maintaining the treaty-country person, or in conducting its operations. The proposed treaty also states that benefits are to be allowed in a case where the competent authority of the country allowing the benefits determines that it would not be appropriate, considering the purposes of the anti-treaty-shopping provision, to deny treaty benefits. The Technical Explanation anticipates that the competent authorities will take into account the principles and examples set forth in the Understanding accompanying the limitation-on-benefits provision of the U.S.-Netherlands tax treaty. The proposed treaty requires each competent authority to consult the other before issuing an adverse ruling.

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

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department to provide additional explanation on how the United States would be able to ensure that the benefits of the proposed treaty would only be available to those who are entitled to receive them. Relevant portions of Treasury's letter responding to this and other inquiries, dated July 5, 1995, are reproduced below:[8]

> 2. Without a stronger information-sharing procedure, how will the United States be able to ensure under this treaty that the benefits of the treaty only go to those who are entitled to receive them?
>
> The provisions of the new treaty regarding information exchange with the French tax authorities are fully consistent with U.S. policy and are similar or identical to those in our recent treaties. Our experience with France under the current treaty has been very positive, and the proposed treaty expands the scope of information exchange in important respects. The French negotiators confirmed that information will continue to be exchanged between the tax authorities as in the past, despite the current disagreement concerning on-site audits. On-site audits serve as a "shortcut" to the exchange of information between tax authorities under our treaties, but they are only one of numerous means of obtaining information. Therefore, we do not anticipate any particular problems in applying the limitation on benefits or other provisions of the treaty.

Triangular structures

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

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

The Committee commends efforts made by the Treasury Department to include effective anti-abuse shopping provisions in bilateral tax conventions, including the proposed treaty. Appropriate steps should be taken to ensure that U.S. taxes are properly paid

[8] Letter from Assistant Secretary of the Treasury (Tax Policy), Leslie B. Samuels to Senator Fred Thompson, Committee on Foreign Relations, July 5, 1995 ("July 5, 1995 Treasury letter").

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

by all corporations, both domestic and foreign, under U.S. income tax treaties. The Committee remains concerned, however, that the application of certain anti-abuse shopping provisions could, in some cases, deny the relief for double taxation from certain U.S. companies with overseas subsidiaries.

The Committee believes that the exemptions allowed in paragraph 5(b) of Article 30 should be granted automatically to any CFCs resident in France to the extent the interest payments to such CFCs are includible in the income of their U.S. shareholders under the provisions of subpart F of the Code. If it is later determined that the payments do not constitute subpart F income and U.S. tax should have been withheld, then the U.S. withholding agent, including the U.S. shareholder of the CFC, should be held liable for penalties for failure to withhold, in addition to the withholding tax. Consequently, subjecting these businesses to additional administrative requirements to demonstrate that the income is taxable under the provisions of subpart F beyond regular audit procedures imposes onerous administrative requirements that are unduly burdensome.

Because taxpayers with CFCs resident in the Netherlands have been subject to the same burdens, the Committee believes that the anti-abuse provision contained in Paragraph 8 of Article 12 of the U.S.-Netherlands tax treaty should be applied in the same manner as the relief available under paragraph 5(b) of Article 30 of the proposed treaty. The Committee further believes that any such relief should be available on a long-term basis.

As part of the consideration of this special rule under the proposed treaty, the Treasury Department was asked to discuss a similar provision contained in the U.S.-Netherlands treaty (as amended by the 1993 protocol), including reasons why permanent relief should not be granted in the case of Dutch finance subsidiaries whose profits are taxable under subpart F of the Code. The relevant portion of Treasury's response to these issues, as indicated in its July 6, 1995, letter to Senator Thompson, is reproduced below:

> 1. Is it not true that since Competent Authority can grant temporary, case-by-case relief under paragraphs 1 and 3 of Article 29 of the Dutch Treaty, permanent Competent Authority relief could be granted and publicized on which affected taxpayers could rely, as was done in Notice 95–31, Revenue Ruling 80–304, Revenue Ruling 77–289, and Revenue Ruling 77–62?
>
> Competent authority relief can take different forms. The form that such relief will take will be dictated by the issue presented. In the authorities cited, the competent authorities either agreed on a common definition of a term that was not otherwise clearly defined, or agreed on a common interpretation of a provision that was unclear in some respect.
>
> Unlike the authorities cited, the agreement in this case does not relate to an ambiguity in the text of the treaty. It relates to a specific group of foreign taxpayers who, together with their current U.S. shareholders, may suffer double taxation of their U.S. source income. I have been

informed by the Assistant Commissioner (International) that agreements between the competent authorities to eliminate double taxation invariably apply to specific taxpayers for a specific year or set of years. This long-standing administrative practice is consistent with the Internal Revenue Service's duty to ensure that the tax laws of the United States are administered appropriately. In a factually-based case involving individual foreign taxpayers it is impossible to anticipate every conceivable change in the relevant facts and circumstances that might occur. It is important for the IRS to be able to examine these structures in order to determine, for example, whether they are being used to evade foreign taxes, or the extent to which the income of the Dutch company is taxed currently as subpart F income.

This approach is consistent with the approach taken to establishing entitlement to treaty benefits generally. For example, foreign taxpayers must file a Form 1001 in order to obtain reduced withholding rates under a tax treaty. This form must be resubmitted every three years.

2. Does the Treasury Department have authority, under paragraph 3 of Article 34, to interpret the Dutch Treaty to carry out the intended purpose of that Treaty?

Paragraph 3 of Article 34 gives Treasury the authority to issue regulations necessary to carry out provisions of the treaty other than those described in paragraphs 1 and 2 of that Article. Paragraph 1 provides that the competent authorities may, by mutual agreement, determine the "mode of application" of Article 12 (Interest) and certain other provisions of the treaty. Consequently, the authority granted by paragraph 3 of Article 34 does not extend to issues arising in connection with Article 12 of the treaty. The payments received by the Dutch taxpayers in these cases are interest payments that fall under paragraph 8 of Article 12 (Interest).

3. Is it not true that beyond the Dutch Treaty itself, the Treasury Department's general authority to interpret the tax law is sufficient to support the issuance of policy guidance?

Congress has historically been reluctant to grant wide discretion to the Treasury Department or the Internal Revenue Service to unilaterally modify the rate of taxation imposed on individual taxpayers, foreign or domestic. Indeed, we do not believe that the Internal Revenue Service has the authority to unilaterally reduce the rate of tax imposed on a particular foreign taxpayer. Tax rates are set by Congress and cannot be altered through unilateral administrative action.

The treaty does, however, provide authority for the competent authorities to reach mutual agreements covering a number of issues that the Internal Revenue Service otherwise might not have authority to resolve, including issues relating to double taxation. All authority to reduce the

U.S. tax rate to which these Dutch companies are subject derives from the treaty.

4. If it were necessary to seek assent of the Netherlands in order to issue such published guidance, is it not highly likely that the Netherlands would accede to such guidance given their approval of relief for 1995?

We have not discussed with the Dutch competent authority the possibility that an agreement to permanently reduce the rate of tax in the instant case be published. In any event, I understand that the Internal Revenue Service would have serious reservations with adopting such a solution. Although the Treasury Department has not been directly involved in any discussions between the affected taxpayers and the Internal Revenue Service, our general familiarity with these cases enables us to fully support the judgment of the Assistant Commissioner (International) in this regard.

5. In the 1993 Protocol, did the Treasury Department cede authority to the Netherlands to resolve problems of U.S. taxpayers?

Not at all. The Internal Revenue Service retains the ability it has under domestic law to resolve problems encountered by U.S. taxpayers, as well as the foreign taxpayers involved in these cases. A tax treaty only increases the IRS's ability to resolve problems. The IRS may use the mutual agreement procedures described in the treaty to resolve a variety of issues, including the issue faced by the Dutch companies that are subject to the 15 percent withholding tax under the Protocol. In these cases, this authority gives the IRS the possibility of reducing the rate of U.S. tax paid by these Dutch companies.

6. Is there any specific reason that permanent relief should not be granted in the case of Dutch finance subsidiaries whose profits are subject to Subpart F of the Tax Code and who properly file annual tax returns?

Ordinarily a foreign subsidiary of a U.S. corporation is not required to file an annual United States income tax return. The tax liability in these cases falls on the foreign corporation, while the correlative Subpart F issue and related IRS audits involve the U.S. parent—this distinction raises technical but important procedural issues.

U.S. tax laws are designed to discourage structures such as those presented in these cases, as such structures were often used to inappropriately avoid U.S. tax. There may be non-U.S. tax reasons for such structures as well. Accordingly, under the Internal Revenue Code, foreign finance subsidiaries that receive related party U.S. source interest income are subject to 30 percent U.S. withholding tax, and the net income of the finance subsidiary is then subject to full U.S. corporate income taxation at the parent company level, with no possibility of a credit for the U.S. and foreign taxes paid at the subsidiary level. Double taxation is virtually inevitable in such cases. The companies involved in these cases effectively have asked that this policy be altered for them. While the treaty makes such a modification possible, we believe that administrative relief should be undertaken with caution when it involves an exception to a Congressionally-mandated policy.

There are sound administrative reasons for not granting a permanent exemption in these cases. There are various ways in which taxpayers can manipulate the earnings and profits of a foreign subsidiary in order to reduce subpart F income. Under the Internal Revenue Code, a U.S. taxpayer is only required to include Subpart F income up to the amount of the foreign subsidiary's earnings and profits. Accordingly, it is possible that a foreign subsidiary could have substantial amounts of subpart F income but the U.S. parent corporation would be required to report little or no subpart F income due to the earnings and profits limitation. Therefore it is important that the IRS retain the ability to confirm that the taxpayer is not manipulating its earnings and profits accounts in order to depress its subpart F income inclusion. The IRS also has a responsibility to our treaty partners to decline to facilitate the evasion of their taxes.

These concerns are especially acute with respect to foreign taxpayers asking for a reduction in their U.S. tax rate. Foreign taxpayers generally are beyond the reach of the U.S. tax collection system. Even a foreign company that is U.S.-owned presents concerns, because the company may not be U.S.-owned when its results are actually subject to audit.

7. The inclusion [of a similar] provision in the French treaty indicates that, should French regulations change, you believe French subsidiaries should be treated differently. Why is this distinction appropriate?

We have not concluded that French companies should be treated differently for this purpose than Dutch companies. We insisted on inclusion of a similar provision in the French treaty precisely because we were concerned that French law might change in the future in a way that would make these structures more feasible. If that occurred it was important that we have a provision in the treaty to prevent abuse.

The French treaty relieves a French company from the U.S. withholding tax if the company's income is subject to Subpart F. The IRS has not determined what procedures it would adopt to implement this provision. The procedures eventually adopted could be comparable to those developed in connection with these cases.

The Committee has recommended that the Senate give its advice and consent to the proposed treaty with a declaration regarding this issue to reflect its beliefs stated above.

Conclusion of the Committee

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

B. TRANSFER PRICING

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

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S.

[10] The OECD report on transfer pricing generally approves the methods that are incorporated in the current Treasury regulations under section 482 as consistent with the arm's-length principles upon which Article 9 of the proposed treaty is based. See OECD Committee on Fiscal Affairs, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators," OECD, Paris 1995.

[11] Id. (preface).

share of multinational income.[12] Some prefer a so-called "formulary apportionment" approach, which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach that is based on the expectation that an investor generally will insist on a minimum return on investment or sales.[13]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimination rules embodied in Article 25.[14] Some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

As part of its consideration of the proposed treaty, the Committee requested the Treasury Department to provide additional information on the Administration's current policy with respect to transfer pricing issues. Among the information requested include a description of the Administration's general position on transfer pricing issues, an analysis of whether the United States should interpret Article 9 of tax treaties regarding transfer pricing as permitting other methods of pricing such as the unitary method or formulary apportionment method and the reasons for industry's support of the arm's-length pricing method. In addition, the Committee

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

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

[14] Compare "Tax Conventions with: The Russian Federation, Treaty Doc. 102–39; United Mexican States, Treaty Doc. 103–7; The Czech Republic, Treaty Doc. 103–17; The Slovak Republic, Treaty Doc. 103–18; and The Netherlands, Treaty Doc. 103–6. Protocols Amending Tax Conventions with: Israel, Treaty Doc. 103–16; The Netherlands, Treaty Doc. 103–19; and Barbados, Treaty Doc. 102–41. Hearing Before the Committee on Foreign Relations, United States Senate," 103d Cong., 1st Sess. 38 (1993) ("A proposal to use a formulary method would be inconsistent with our existing treaties and our new treaties.") (oral testimony of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Treasury Department); a statement conveyed by foreign governments to the U.S. State Department that "[worldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State); and "American Law Institute Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties" (1992), at 204 (n. 545) ("Use of a world-wide combination unitary apportionment method to determine the income of a corporation is inconsistent with the 'Associated Enterprises' article of U.S. tax treaties and the OECD model treaty") with "Hearing Before the Senate Committee on Governmental Affairs" at 26, 28 ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder). See also "Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means," 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

also inquired whether the Treasury Department is satisfied that the proposed treaty, and other treaties that are the subject of the hearing, ensure foreign corporations are paying their share of U.S. taxes. Relevant portions of Treasury's response to these inquiries, in the July 5, 1995, Treasury letter, are reproduced below:

> 1. Please describe the position of the U.S. Treasury with regard to the transfer pricing issue.
>
> While estimates of the magnitude of the problem vary, Treasury regards transfer pricing as one of the most important international tax issues that it faces. Treasury believes that both foreign and U.S.-owned multinationals have engaged in significant income shifting through improper transfer pricing.
>
> Treasury identified three problems that allowed these abuses to occur: (1) lack of substantive guidance in U.S. regulations for taxpayers and tax administrators to apply in cases where the traditional approaches did not work; (2) lack of an incentive for taxpayers to attempt to set their transfer prices in accordance with the substantive rules; and (3) lack of international consensus on appropriate approaches. To resolve these problems, Treasury has taken the following steps in the last two years:
>
>> In July 1994, Treasury issued new final regulations under section 482 of the Internal Revenue Code. These regulations contain methods that were not reflected in prior final regulations: the Comparable Profits and Profit Split Methods. These methods are intended to be used when the more traditional methods are unworkable or do not provide a reliable basis for determining an appropriate transfer price.
>>
>> In August 1993, Congress enacted a Treasury proposal to amend section 6662(e) of the Internal Revenue Code. This provision penalizes taxpayers that both (1) are subject to large transfer pricing adjustments and (2) do not provide documentation indicating that they made a reasonable effort to comply with the regulations under section 482 in setting their transfer prices. Treasury issued temporary regulations implementing the statute in February 1994.
>>
>> In July 1994, the Organization for Economic Cooperation and Development issued a draft report on transfer pricing. The United States is an active participant in this body. The OECD transfer pricing guidelines serve as the basis for the resolution of transfer pricing cases between treaty partners and it therefore is critical that any approach adopted in any country be sanctioned in this report in order to reduce the risk of double taxation. The draft report permits the use of the new U.S. methods in appropriate cases.
>
> 2. Why shouldn't the United States interpret Article 9 of the tax treaties regarding transfer pricing as permitting other methods of pricing such as the unitary or formulary apportionment method?

If Treasury adopted such an interpretation, it would send a signal to our treaty partners that we were moving away from the arm's length standard to a different, more arbitrary approach. Sending such a signal would be very destructive and, if implemented, would inevitably result in double (and under) taxation due to the fundamental inconsistency between the approach used in the United States and that used elsewhere. Further, adopting such an interpretation would invite non-OECD countries to introduce their own approaches that currently cannot be foreseen, but that could inappropriately increase their tax bases at the expense of the United States and other countries.

3. The consensus regarding transfer pricing methods is currently the arm's length standard. Will the U.S. remain open to the possibility of better or alternative methods without moving to such alternative methods unilaterally?

If it appeared that another approach was superior to the current approach, the U.S. would push for the adoption of this new approach on a multilateral basis so that there would be the necessary international consensus in favor of the new approach.

4. Why does industry support the arm's length pricing method?

Most multinationals are willing to pay their fair share of tax. Their primary concern is that they not be subjected to double taxation. Because the arm's length standard is the universally adopted international norm and the major countries of the world have adopted a consensus interpretation of that standard within the OECD, the risks of double taxation are infinitely smaller under the arm's length standard than under any other approach.

5. A recent GAO report suggested that many foreign corporations are not paying their fair share of taxes. Is Treasury satisfied that these treaties ensure full payment of required taxes?

A tax treaty by itself will not prevent transfer pricing abuses. Rather, the treaty leaves it to the internal rules and practices of the treaty partners to deal with such issues. In the United States, Treasury has taken the measures described above to ensure that foreign—and domestic—corporations pay their fair share of taxes. A tax treaty can make these internal measures more effective, particularly through the exchange of information provisions that enable the U.S. tax authorities to obtain transfer pricing information on transactions between related parties in the United States and the treaty partner. The treaties also facilitate Advance Pricing Agreements that preclude the possibility of double taxation and at the same time ensure that each country receives an appropriate share of the taxes paid by a multinational.

C. RELATIONSHIP TO OTHER TREATIES AND AGREEMENTS

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

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

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

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

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

Agreement on Tariffs and Trade ("GATT") with respect to trade in goods).

The Committee believes that it is important that the competent authorities are granted the sole authority to resolve any potential dispute concerning whether a measure is within the scope of the proposed treaty and that the nondiscrimination provisions of the proposed treaty are the only appropriate nondiscrimination provisions that may be applied to a tax measure unless the competent authorities determine that the proposed treaty does not apply to it (except nondiscrimination obligations under GATT with respect to trade in goods). The Committee also believes that the provision of the proposed treaty is adequate to preclude the preemption of the mutual agreement provisions of the proposed treaty by the dispute settlement procedures under the GATS.

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

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

Even if, as some have argued, the nondiscrimination provisions of the 1959 Convention may limit the scope or structure of U.S. taxation of French enterprises under present law, the Committee believes that Article 29(8) of the proposed treaty preclude any such limitation as discussed above.[15]

D. INSURANCE EXCISE TAX

The proposed treaty, like the present treaty, contains a waiver of the U.S. excise tax on insurance premiums paid to foreign insurers. Thus, for example, a French insurer or reinsurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of this tax. However, the tax is imposed to the extent that the risk is reinsured by the French insurer or reinsurer with a person not entitled to the benefits of the proposed treaty or another treaty providing

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

exemption from the tax. This latter rule is known as the "anti-conduit" clause.

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

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

However, French law may exempt low-taxed foreign income of a French resident from tax; if foreign laws that apply to the foreign insurance income of a French resident were changed in the future (or applied differently than they are now), the result might be a level of tax inconsistent with the criteria previously laid down by the Committee for waiver of the U.S. excise tax on premiums. While the Committee has no reason currently to expect that such foreign law changes will occur, the Committee instructs the Treasury Department promptly to inform the Committee of any changes in foreign laws or business practices that would have an impact on the tax burden of French insurers relative to that of U.S. insurers.

E. EXCHANGE OF INFORMATION

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

The proposed treaty provides for representatives of one country to enter the other country to interview taxpayers and to examine and copy books and records, but only with the consent of the taxpayer and of the other competent authority. Moreover, this provision will not be effective until the United States and France agree to allow such interviews and examinations on a reciprocal basis,

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

and signify that agreement in an exchange of diplomatic notes. That is, unless and until a subsequent agreement is reached, the United States has no authority under the treaty to enter France for audit purposes. After such agreement is reached, the authority to conduct such audits in France (as under some other U.S. treaties) would be available only with the consent of the taxpayer.

However, the opportunities for obtaining tax information from France is significantly greater under the proposed treaty than under present law and practice. The Committee understands that French law precludes foreign government authorities, including agents of the United States and other treaty partners, from conducting on-site tax examinations in France even with consent of the taxpayer. There is no current limitation applicable to on-site tax examinations by French authorities in the United States. In fact, the Treasury Department has confirmed that France tax authorities do conduct such examinations from time to time. The proposed treaty would restore reciprocity to this relationship by limiting the ability of the French tax authorities to conduct on-site examinations in the United States until both countries agree to permit such examinations. The provision may serve to encourage France to modify its internal laws so that both countries could more effectively enforce their tax laws.

As part of its consideration of the proposed treaty, the Committee raised the issue as to whether the United States can be assured that an exchange of notes regarding on-site audits will be forthcoming. The Committee also asked the Treasury Department whether the United States will be able to properly determine the tax obligations of French taxpayers who refuse to submit to the information sharing provisions. Relevant portions of Treasury's response to these inquiries, in the July 5, 1995, Treasury letter, are reproduced below:

> 1. What assurance does the United States have from France that an exchange of notes [regarding on-site audits] will be forthcoming?
>
> We have not yet received assurances from the French negotiators regarding on-site audits. If the French tax officials had authority to resolve the issue, we would have insisted on doing so in the treaty itself. The problem is that on-site audits by foreign government officials are prohibited under French law. The treaty levels the playing field by introducing a similar prohibition against on-site audits by French officials in the United States until such time as their Government permits U.S. agents to conduct audits in France. The treaty, therefore, creates a strong incentive for France to change its current policy.
>
> 3. How will the United States be able to properly determine the tax obligations of French taxpayers who refuse to submit to the information sharing provisions?
>
> The French Government routinely provides tax information to the Internal Revenue Service under the information exchange provisions of the current treaty without the taxpayer's consent. The provisions of the new treaty will not change this. Therefore, we do not anticipate any particular

> difficulty in determining the U.S. tax obligations of French taxpayers.
>
> The taxpayer's consent will be required only for an on-site audit, which as noted above are only one of several tools for obtaining information. This requirement is standard practice. Many other countries—including the United States—permit on-site audits by foreign government officials only with the permission of the taxpayer.

The Committee has considered the extent to which the limited examination opportunities under the proposed treaty would be adequate to allow the United States to properly determine the tax obligations of French persons, and to confine the benefits of the French treaty to those taxpayers entitled to receive them and has not recommended a reservation or understanding in this case. However, the Committee believes that the exchange of information provisions in treaties are central to the purposes for which tax treaties are entered into, and it does not believe that significant limitations on their effect, relative to the preferred U.S. tax treaty position, should be accepted by the Administration in its negotiations with other countries that seek to have or to maintain the benefits of a tax treaty relationship with the United States.

F. ARBITRATION OF COMPETENT AUTHORITY ISSUES

In a step that has been taken only recently in U.S. income tax treaties (i.e., beginning with the 1989 income tax treaty between the United States and Germany and the 1992 income tax treaty between the United States and the Netherlands), the proposed treaty delegates to the executive branch the power to enter into, an agreement under which a binding arbitration procedure may be invoked, if both competent authorities and the taxpayers involved agree, for the resolution of those disputes in the interpretation or application of the treaty that it is within the jurisdiction of the competent authorities to resolve. This provision is effective only after diplomatic notes with respect to this issue are exchanged between France and the United States. Consultation between the two countries regarding whether such an exchange of notes should occur will take place after there has been sufficient experience with other treaties containing a similar provision.

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

As an initial matter, it is necessary to recognize that there are appropriate limits to the competent authorities' own scope of review.[17] The competent authorities would not properly agree to be

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

> Under a literal reading, this delegation could be interpreted to include double taxation arising from any source, even state unitary tax systems. Accordingly, the scope

Continued

bound by an arbitration decision that purported to decide issues that the competent authorities would not agree to decide themselves. Even within the bounds of the competent authorities' decision-making power, there likely will be issues that one or the other competent authority will not agree to put in the hands of arbitrators. Consistent with these principles, the Technical Explanation expects that the arbitration procedures will ensure that the competent authorities will not generally accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either treaty country.

As stated in recommending ratification of the U.S.-Germany treaty and the U.S. Netherlands treaty, the Committee still believes that the tax system potentially may have much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes that otherwise may impede efficient administration of the tax laws. However, the Committee believes that the appropriateness of such a clause in a treaty depends strongly on the other party to the treaty, and the experience that the competent authorities have under the corresponding provision in the German and Netherlands treaties. The Committee understands that to date there have been no arbitrations of competent authority cases under the German treaty or the Netherlands treaty, and few tax arbitrations outside the context of those treaties. The Committee believes that the negotiators acted appropriately in conditioning the effectiveness of this provision on the outcome of future developments in this evolving area of international tax administration.

VII. Technical Clarifications

A. Stock exchange excise tax

Under the present treaty, the French tax on stock exchange transactions is a covered tax. That is, the tax could not be imposed on a resident of the United States. In the proposed treaty, however, the French tax on stock exchange transactions is not a covered tax, but Article 29(4) provides that any transaction in which an order for the purchase, sale, or exchange of stocks or securities originates in one treaty country and is executed through a stock exchange in the other treaty country is exempt in the first country from stamp or like tax otherwise arising with respect to such transaction. The apparent difference between these provisions is that the French tax on stock exchange transactions could be imposed, under the proposed treaty, on a U.S. resident who engages in a stock exchange transaction while in France on a temporary basis. However, the Committee understands that French law now exempts nonresident individuals and foreign legal persons from the tax on stock exchange transactions.

B. Treatment of partnerships

As noted above, the proposed treaty provides that a partnership or other entity that is subject to tax by a treaty country at the en-

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of this delegation of authority must be clarified and limited to include only non-controversial technical matters, not items of substance.

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

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

VIII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to have a negligible effect on annual Federal budget receipts during the fiscal year 1995–2000 period.

IX. Explanation of Proposed Treaty

For a detailed article-by-article explanation of the proposed tax treaty, see the "Treasury Department Technical Explanation of the Convention Between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Signed at Paris on August 31, 1994."

X. Text of the Resolution of Ratification

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the Government of the United States of America and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, signed at Paris on August 31, 1994, together with two related exchanges of notes (Treaty Doc. 103–32). The Senate's advice and consent is subject to the following declaration, which shall not be included in the instrument of ratification to be signed by the President:

That it is the Sense of the Senate that the tax relief available under paragraph 5(b) of Article 30 of the proposed Convention, which exempts certain interest payments to French subsidiaries from United States tax to the extent that United States tax is imposed on such payments under subpart F of Part III of subchapter N of chapter 1 of subtitle A of the Internal Revenue Code ("subpart F"), should be automatically available to any French subsidiary that is a controlled foreign corporation under Section 957 of the Internal Revenue Code to the extent that such payments are taxed under subpart F. The Treasury Department and the Internal Revenue Service shall negotiate with their Dutch counterparts an application of Paragraph 8 of Article 12 of the U.S.-Netherlands Tax Treaty consistent with the French Treaty as described above and grant a long-term exemption from United States tax for interest paid to Dutch subsidiaries to the extent such interest is taxed under subpart F.

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