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The United States - French Income Tax Convention

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THE UNITED STATES—FRENCH INCOME TAX CONVENTION

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INCOME tax conventions have been used by the United States for nearly forty years[1] to relieve double taxation and prevent evasion of taxes. Recent conventions manifest a change in the terms for which the United States presses in treaties with other "developed" countries. This article will attempt to analyze the provisions of the most recent tax convention[2] negotiated by the United States and France in order to set forth the meaning of terms and phrases that are likely to be used often in future United States tax conventions.

The 1967 Convention will be a particularly important tool for analyzing future income tax conventions. It is the first convention with a developed country negotiated in the light of the Organization for Economic Cooperation and Development Draft,[3] a model convention drafted primarily by European countries to harmonize their tax systems.[4] Sec-

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1. The first tax convention concluded by the United States was with France in 1932. For a discussion thereof, see McCaffery, The Franco-American Convention Relative to Double Taxation, 36 Colum. L. Rev. 382 (1936) [hereinafter cited as McCaffery].

2. Convention with the French Republic with Respect to Taxes on Income and Property, July 28, 1967, [1968] 4 U.S.T. 5280, T.I.A.S. No. 6518 (effective Aug. 11, 1968) [hereinafter cited as 1967 Convention]. This convention can also be found at 1 CCH Tax Treaties ¶ 2839 (1968). The 1967 Convention supersedes the Convention and Protocol with the French Republic Respecting Double Taxation, July 25, 1939, 59 Stat. 893 (1945), T.S. No. 988 (effective Jan. 1, 1945) [hereinafter cited as 1945 Convention and 1945 Convention Protocol, respectively], as supplemented, Convention and Supplementary Protocol with France Respecting Double Taxation and Taxes on Estates, Inheritances, and Income, and Modifying and Supplementing the Convention of July 25, 1939, Oct. 18, 1946, supplementary protocol signed May 17, 1948, 64 Stat. B4 (1950-51), T.I.A.S. No. 1982 (effective Jan. 1, 1950) [hereinafter cited as 1945 Convention Supplementary Protocol], as supplemented, Convention with the French Republic Supplementing the Conventions of July 25, 1939 and October 18, 1946, Relating to the Avoidance of Double Taxation, as Modified and Supplemented by the Protocol of May 17, 1948, June 22, 1956, [1957] 1 U.S.T. 843, T.I.A.S. No. 3844 (effective June 13, 1957). The 1945 Convention can also be found at 1 CCH Tax Treaties ¶ 2803 (1970).

3. Organization for Economic Cooperation and Development Fiscal Committee, Report, Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital (1963) [hereinafter cited as OECD Draft], reprinted at 1 CCH Tax Treaties ¶ 151 (1966). See Remarks of Stanley S. Surrey, Assistant Secretary of the Treasury, to the American Chamber of Commerce Abroad, at Washington, D.C., April 30, 1968, Treas. Dep't Release No. F-1228, at 2 (April 30, 1968) [hereinafter cited as Chamber Talk].

4. The United States and Canada were not strong voices in the development of the OECD Draft, and there are many places where it meshes poorly with the domestic tax concepts of the United States. OECD Draft 19; Tillinghast, The Revision of the Income Tax Convention

ond, it is the first complete convention negotiated by the United States with an eye firmly fixed on the new system of taxing nonresident aliens and foreign corporations established in 1966 by the Foreign Investors Tax Act.[5] Third, it is the first complete convention negotiated with a country using an integrated taxing system for corporate income taxation and for dividends distributed by corporations. This system has the same effect as a split tax rate in that it is more advantageous from a tax point of view to distribute dividends than to retain earnings in the corporation.[6] The French system, because it gives relief to the shareholders rather than the corporation,[7] is perhaps the most difficult of these systems to neutralize. Fourth, the contracting states use different unilateral measures for the relief of double taxation. France relies primarily on the exemption method,[8] while the United States uses the credit method.[9] Adjusting these disparate systems is more difficult than harmonizing similar methods. Finally, the 1967 Convention will set the pattern for a major round of negotiations and renegotiations with other developed nations.[10]

I. GENERAL RULES

The 1967 Convention changes the general pattern of our income tax conventions in certain respects. Business profits[11] of a resident of one

between the United States and the Federal Republic of Germany, 21 Tax L. Rev. 399 (1966) [hereinafter cited as Tillinghast]. But see Kragen, Taxation Treaties: The O.E.C.D. Draft, 52 Calif. L. Rev. 306, 308 (1964) [hereinafter cited as Kragen].

5. Act of Nov. 13, 1966, Pub. L. No. 89-809, 80 Stat. 1539 [hereinafter cited as Foreign Investors Act]. See J. Chommie, Federal Income Taxation §§ 213-15 (1968) [hereinafter cited as Chommie]; S. Roberts & W. Warren, Foreign Investors Tax Act (1967); Note, The Bases for Taxing Foreign Corporations and Nonresident Alien Individuals on Income from Sources Within and Without the United States, 52 Minn. L. Rev. 1261 (1968).

6. Germany uses a split rate (which reaches the same result by a different theory), Harvard Law School, World Tax Series, Taxation in Germany 143 (1963), but the renegotiation with Germany was only a partial one. Norr, The French Reform of Dividend Taxation and Common Market Tax Harmonization, 44 Taxes 320 (1966) [hereinafter cited as Norr]; Tillinghast 400-01.

7. Norr 321; Tillinghast 400 n.5.

8. Harvard Law School, World Tax Series, Taxation in France § 11/2.18a (1966) [hereinafter cited as France].

9. Int. Rev. Code of 1954, §§ 901-06.

10. Negotiations are now in progress or have been completed with Belgium, Finland, Japan, Portugal and Spain, among others, and these negotiations will take or have taken the 1967 Convention as their model. Treas. Dep't Release No. F-1331 (Aug. 21, 1968); Chamber Talk 3. There are also negotiations taking place with several less industrialized nations. Many of the clauses in United States tax conventions with industrialized countries are copied in conventions with developing nations. Discussions with Treasury Department officials indicate that plans for comprehensive convention regulations have been abandoned. Instead, regulations under the 1967 Convention will serve as a model for other regulations.

11. The term "business profits" is used throughout this article in place of the term

country earned in the other country are taxable in the source country only to the extent that they are effectively connected with a permanent establishment located therein. Investment income is generally entitled to exemption from tax or reduced rates in the source country, except that investment income which is effectively connected with a permanent establishment is taxed as business profits.[12] A new feature of income tax conventions appears in the 1967 Convention, namely, that royalties are taxable in the source country to prevent tax evasion.[13] The 1967 Convention also contains more liberal provisions than the 1945 Convention concerning income from personal services (including income of teachers, students and trainees).[14] The spirit of administrative assistance strongly evident in all tax conventions continues in the 1967 Convention. Double taxation is relieved for United States citizens, residents and corporations by the credit mechanism, and for French residents and corporations, by a combination of the credit and exemption methods, with the emphasis on the credit method.

II. Coverage

The 1967 Convention applies to all income taxes imposed by the contracting states,[15] including the personal holding company tax and the accumulated earnings tax.[16] The enumeration of taxes indicates that the

"industrial or commercial profits" because the latter term can be misleading. "Industrial or commercial profits" include "income derived from manufacturing, mercantile, agricultural, fishing, or mining activities, from the operation of ships or aircraft, from the furnishing of personal services, from the rental of tangible personal property, and from insurance activities and rents or royalties derived from motion picture films, films or tapes of radio or television broadcasting," 1967 Convention, art. 6(5), much of which is neither industrial nor commercial, but is normally considered business profits. The term "business profits" is also shorter, thereby being an easier term to use.

12. See text accompanying notes 266-318 infra.

13. See text accompanying notes 322-34 infra.

14. See text accompanying notes 335-426 infra.

15. 1967 Convention, art. 1(1).

16. The personal holding company tax (Int. Rev. Code of 1954, §§ 541-47) is clearly an income tax. The accumulated earnings tax (Int. Rev. Code of 1954, §§ 531-37) is not, but its position in Subtitle A of the Code, "Income Taxes," argues for inclusion as an income tax. More significantly, the 1967 Convention specifically refers to both taxes in Article 13(1)(b). Specific inclusion is not unusual. See Convention and Protocol with Canada Respecting Double Taxation, March 4, 1942, art. XIII, 56 Stat. 1399 (1942), T.S. No. 983 (effective retroactively Jan. 1, 1941), 1 CCH Tax Treaties ¶ 1219 (1966) [hereinafter cited as Canadian Convention and Canadian Convention Protocol, respectively], as amended, Convention Modifying and Supplementing the Convention and Accompanying Protocol of March 4, 1942, June 12, 1950, art. I(h), [1951] 2 U.S.T. 2235, T.I.A.S. No. 2347 (effective Nov. 21, 1951), as supplemented, Convention with Canada Further Modifying and Supplementing the Convention and Accompanying Protocol of March 4, 1942 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, as Modified by the Supplementary Convention of June 12, 1950, Aug. 8, 1956, [1957] 2 U.S.T.

term "income taxes" include surtaxes[17] and surcharges.[18] Thus, residents of convention partners with fixed limits on United States taxes will be the only ones to escape the Vietnam-related surcharges.[19] This

1619, T.I.A.S. No. 3915 (effective Sept. 26, 1957); Convention with United Kingdom Respecting Double Taxation and Taxes on Income and Protocol, April 16, 1945, art. XVI, 60 Stat. 1377 (1946), T.I.A.S. No. 1546 (effective retroactively Jan. 1, 1945), 2 CCH Tax Treaties ¶ 8121 (1964) [hereinafter cited as United Kingdom Convention], as amended, Supplementary Protocol Amending the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on the 16th April, 1945, as Modified by Supplementary Protocol, Signed at Washington on the 6th June, 1946, May 25, 1954, [1955] 1 U.S.T. 37, T.I.A.S. No. 3165 (effective Jan. 19, 1955), as amended, Supplementary Protocol with the United Kingdom of Great Britain and Northern Ireland Amending the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on the 16th April 1945, as Modified by the Supplementary Protocol Signed at Washington on the 6th June 1946 and by the Supplementary Protocol Signed at Washington on the 25th May 1954, Aug. 19, 1957, [1958] 1 U.S.T. 1329, T.I.A.S. No. 4124 (effective Oct. 15, 1958), as amended, Supplementary Protocol with the Government of the United Kingdom of Great Britain and Northern Ireland, Amending the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Signed at Washington on the 16 April, 1945, as Modified by the Supplementary Protocols Signed in Washington on the 6th June, 1946, the 25th May, 1954, and the 19th August, 1957, March 17, 1966, [1966] 1 U.S.T. 1254, T.I.A.S. No. 6089 (effective Sept. 9, 1966) [hereinafter cited as United Kingdom Supplementary Protocol].

It has been argued that many tax conventions implicitly include these taxes by indirection when they exempt from United States tax, dividends and interest paid by foreign corporations to nonresident aliens or foreign corporations. S. Roberts & W. Warren, U.S. Income Taxation of Foreign Corporations & Nonresident Aliens ¶ X/6B(1)(a) (1966) [hereinafter cited as Foreign Tax]. The argument is that a foreign corporation may only be subject to the accumulated earnings tax if its shareholders are subject to United States income tax. Id. ¶ X/2A-2B(2); Alexander, Foreign Personal Holding Companies and Foreign Corporations That Are Personal Holding Companies, 67 Yale L.J. 1173, 1174, 1194, 1196 (1958). This argument depends largely on the application of the maxim inclusio unius est exclusio alterius to Treas. Reg. § 1.532-1(c) (1960). The validity of this interpretation depends on the view that the accumulated earnings tax is only intended to thwart avoidance of United States income tax by the shareholder, a view which the United States Senate did not share in its reservation to the income tax conventions with Ireland. S. Exec. Rep. No. 1, 82d Cong., 1st Sess. 20 (1951); 97 Cong. Rec. 11,458 (1951). Nor did it share this view in its reservation to the United States income tax convention with the Netherlands. S. Exec. Rep. No. 11, 80th Cong., 2d Sess. 2 (1948); 94 Cong. Rec. 8625 (1948). However, the Senate's ratification of the 1967 Convention argues the other way, as does Int. Rev. Code of 1954, § 542(c)(7), which provides that a foreign corporation wholly owned by nonresident alien individuals is not a personal holding company.

17. 1967 Convention, art. 1(1)(a). One example would be the surtax on corporations provided by Int. Rev. Code of 1954, § 11.

18. S. Exec. Doc. N, 90th Cong., 1st Sess. V (1967). This is logical since a surcharge on income is a federal income tax under Article 1(1)(a) of the 1967 Convention, or because it is an identical or substantially similar tax under Article 1(3) of the 1967 Convention.

19. Int. Rev. Code of 1954, § 51.

type of coverage is proper and should continue in other tax conventions. Although it can be argued that when one makes investments in a country, he partakes of the benefits provided by that government and, therefore, should support it, surcharges and surtaxes are usually only imposed as a result of some national crisis. To the extent that foreign investors have placed investment funds in a country in reliance on a fixed limitation in the rate of tax or exemption from tax, this expectancy should not be disturbed. The same rationale would also apply to a business which is not conducted through a permanent establishment.

The 1967 Convention also has provisions dealing with withholding and estimated taxes.[20] One of the reasons proffered for reduced rates and exemptions from tax is that the administrative work required of individuals in ascertaining and paying the tax is not justified because of their minimal economic penetration of the source country. If withholding and estimated taxes were imposed regardless of an exemption from or reduction in the rate of tax for which they provide payment, the taxpayer would be put to a double burden of paying the withholding and estimated tax, and then having to file for an appropriate refund.

The weight of this justification is slight. The additional work required to file a claim for refund, where the taxpayer's only income from abroad is from investment income, is minimal. The danger of evasion from a withholding system such as the United States uses, relying on the taxpayer's address to reduce withholding, is grave. However, the danger of evasion is minimized in France because shares of stock are generally held by French banks, which collect the tax where appropriate and pay it over to the United States. It is apparently quite difficult to cash a dividend check in France, because of the specific identification that it has, without going through a bank that would be familiar with withholding rules. Although adequate weighing of these policies, along with the ease of administration provided by reduced withholding, should call for a system of full withholding followed by claims for refunds, the United States interprets all of its tax conventions to require reduced withholding, and the 1967 Convention will be no exception.

The 1967 Convention also applies to the French tax on stock exchange

20. 1967 Convention, art. 1(1)(b)(i) specifically mentions the French precompte, and 1967 Convention, arts. 31(1)(a)(i)-(b)(i) & 32(1)(a)-(2)(a) refer specifically to both French and United States withholding taxes. Even in the absence of a specific reference, withholding taxes should be included. Subtitle A of the Int. Rev. Code of 1954 is entitled "Income Taxes" and includes the provisions for withholding of tax on investment income, and Chapter 24, which provides for withholding of tax on wages, is entitled "Collection of Income Tax at Source on Wages." The Commissioner has consistently considered himself bound in imposing withholding taxes by the convention limitations on the imposition of income tax. See, e.g., Treas. Reg. § 510.4(b)(1) (1960).

transactions,[21] and to any documentary taxes on the transfer of securities which might be imposed after the signing of the convention.[22] The French registration tax on incorporation into capital of undistributed profits is also covered by the new convention.[23] It is unusual to include such excise provisions in an income tax convention. However, this is not precedent for extending the scope of United States tax conventions, as it stems from a series of specific difficulties we have had with France, rather than from a goal related to the operation of tax conventions.

For purposes of the nondiscrimination provision only, the new convention applies to all taxes, whether imposed at the national, state, or local level.[24] This provision is quite common in United States tax conventions[25] and is rather remarkable in that it restricts the taxing rights of our fifty states, as it assures that they accord national treatment in taxation to residents of the convention partner. The United States, on the other hand, generally secures the inclusion of all foreign income taxes, as many foreign governments have no local levies.[26] The Treasury Department has been reluctant to restrict the ability of the states to tax foreign residents. As the inhibition is not based on constitutional strictures,[27] it must be attributed to political considerations. It is per-

21. 1967 Convention, art. 1(1)(b)(ii). See France § 4/10.5, at 252-53.

22. 1967 Convention, art. 1(2). This clause seems designed to assure that United States stock transfer taxes, which were repealed in 1965 by the Excise Tax Reduction Act, are never reimposed on French residents. Act of June 21, 1965, Pub. L. No. 89-44, § 401, 79 Stat. 136.

23. 1967 Convention, art. 13(2)(b).

24. Id., art. 1(4). Hearings on Exec. Doc. N., Tax Convention with France, Before the Senate Comm. on Foreign Relations, 90th Cong., 1st Sess. 46 (1968) [hereinafter cited as Hearings].

25. E.g., Convention with the Republic of Austria for the Avoidance of Double Taxation with Respect to Taxes on Income, Oct. 25, 1956, art. XVIII, [1957] 2 U.S.T. 1699, T.I.A.S. No. 3923 (effective retroactively Jan. 1, 1957), 1 CCH Tax Treaties ¶ 521 (1957); Convention with the Republic of Honduras for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, June 25, 1956, art. XX (5), [1957] 1 U.S.T. 219, T.I.A.S. No. 3766 (effective retroactively Jan. 1, 1957) (terminated Dec. 31, 1966 by Honduras). However, it was not found in the old convention, where the nondiscrimination provision was limited to income and stock transfer taxes. 1945 Convention Protocol, art. V.

26. Where foreign local taxes are significant, the negotiators try to cover them. See Convention with the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, May 24, 1951, art. I(1)(b), [1951] 2 U.S.T. 1751, T.I.A.S. No. 2316 (effective Sept. 27, 1951), 2 CCH Tax Treaties ¶ 7404 (1968), which covers Swiss cantonal and communal taxes.

27. U.S. Const., art. VI, cl. 2; see Missouri v. Holland, 252 U.S. 416 (1920); Scandinavian Airlines Sys., Inc., v. County of Los Angeles, 56 Cal. 2d 11, 37-42, 363 P.2d 25, 40-44, 14 Cal. Rptr. 25, 40-44 (1961) (alternative holding), cert. denied, 368 U.S. 899 (1961). There is no greater constitutional support for the provision requiring national treatment than

haps thought just to equalize the tax burdens of local and foreign enterprises through a national treatment clause, but unjust to local enterprises to grant a reduced rate or exemption to foreigners.[28] As will be seen later,[29] state and local income taxes should at least be covered under the personal services provisions of the 1967 Convention.

The operative term of the 1945 Convention with respect to business income was "enterprise."[30] The old convention specifically defined the term to include a partnership.[31] Thus, two Panamanian citizens might form a United States partnership to obtain business profits from France without tax. Since the partnership would not be taxed in the United States,[32] and the partners were not taxed by the United States,[33] the only tax imposed on the French income would be Panama's. This provision allowed aliens to gain the benefits of the convention simply by forming a United States partnership. The Treasury has attempted to plug this loophole by regulation,[34] but has not done so with France.[35]

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there is for a provision exempting foreign residents from state tax entirely on certain types of income.

Limitation on state taxation of foreign corporations and nonresident aliens covered by a tax convention is indirectly achieved where a state income tax law begins with federal adjusted gross income. See, e.g., N.Y. Tax Law §§ 605(2)(c), 631(a) & 632 (McKinney Supp. 1970); Foreign Tax ¶ IX/8C. But this exemption is at the will of the state, not the federal, government.

28. The advantage is more apparent than real, since most of our tax convention partners impose substantial taxes on the foreign income of their residents. In view of this, the foreign enterprise would not gain a competitive advantage over United States firms. France is an exception, as it exempts from its tax the foreign income of French corporations. France § 11/2.18a.

29. See text accompanying notes 355-56 infra.

30. 1945 Convention, art. 3. The term "enterprise" is a word of art in French domestic law—a generic term for business entities. It would include corporations, partnerships, sole proprietorships, trusts, and other entities carrying on business. For the definition in another context, see Lazerow, Price Discrimination and the Treaty of Rome: The Jurisdictional Elements, 23 Fed. B.J. 147, 162-64 (1963).

31. 1945 Convention Protocol, art. III(b).

32. Int. Rev. Code of 1954, § 701; Foreign Tax ¶ VI/4E.

33. The United States taxes the income of nonresident aliens only to the extent that it is derived from sources within the United States, Int. Rev. Code of 1954, §§ 871, 872(a), or to the extent that it constitutes certain kinds of income effectively connected with a trade or business in the United States carried on by the alien through a fixed place of business. Id. § 864(c)(4). The Foreign Investors Act does not change this result. S. Roberts & W. Warren, Foreign Investors Tax Act S/7 (1967) (supplement to Foreign Tax).

34. E.g., Treas. Reg. § 504.120(c) (1960).

35. French partnerships are treated in the same fashion as United States partnerships—the partner is taxed on his allocated share of the income, whether distributed or not. France § 5/3.1. Like United States partnerships before 1969, French partnerships may elect to be taxed as corporations. Id.

In the new convention, the operative term is "resident" for all articles. A resident of the United States is defined as a United States corporation and any person (other than a corporation) "who is resident in the United States for purposes of its tax . . . ."[36] Residents of France are defined similarly, *mutatis mutandis*.[37] The new convention's definition of resident is awkward under the laws of both nations. Neither country's tax law considers partnerships either resident or nonresident, except where such partnerships are taxed as corporations.

A similar problem applies to trusts and estates. The United States classifies trusts and estates as either resident or nonresident, with resident foreign trusts being subjected to liability for world-wide income.[38] The defining of residence in the case of foreign trusts is one of the most difficult problems of United States law, and depends on the residence of the trustee, the grantor, the beneficiaries, the situs of the trust corpus and the investments of the trust.[39] However, with France, the problem is considerably simpler. There is no such thing under French domestic law as a resident trust or estate for tax purposes. The institution of the trust does not exist[40] and the estate is not a taxable entity.[41] Each heir is taxed on his aliquot share of the income from the estate. Although it is not quite clear, foreign trusts are normally taxed in France on a "pass-through" basis. Their distributions are taxed to the beneficiaries as dividends. Where the beneficiary can establish that he cannot reach the income, it will be taxed to the trust.[42]

Moreover, things are complicated by the United States system of taxing trusts. Simple trusts are taxed as conduits, with their income taxed to the beneficiaries.[43] Complex trusts are taxed as conduits when the

36. 1967 Convention, art. 3(2)(b). This is a big improvement on the former standard convention provisions that defined United States resident as a "United States corporation or other entity." For problems inherent in this definition, see Foreign Tax ¶ IX/10F.

37. 1967 Convention, art. 3(1).

38. Int. Rev. Code of 1954, § 7701(a)(31) defines a foreign trust or estate as one not subject to United States tax on world-wide income. Section 641(a) taxes trusts in the same manner as individuals, and from section 871 we learn that nonresident alien individuals are not taxed on their world-wide income. It is thus concluded that nonresident trusts and estates are foreign trusts and estates.

39. Harvard Law School, World Tax Series, Taxation in the United States § 11/4.5, at 1103-04 (1963); Foreign Tax ¶ II/5A-5B; Hammerman, Foreign Situs Trusts—Defining the Undefined, 38 Taxes 529 (1960).

40. There is the institution of the usufruct, which is more like the common law use before the Statute of Uses or, in substance, a legal life estate. See generally McClean, The Common Law Life Estate and the Civil Law Usufruct: A Comparative Study, 12 Int'l & Comp. L.Q. 649 (1963). Income is generally taxed to the beneficiary. France § 5/3.4.

41. France § 5/3.5.

42. See id. § 11/2.14.

43. Int. Rev. Code of 1954, §§ 651-52; Chommie § 127, at 316.

income is distributed to the beneficiaries in the year earned,[44] and under other special conditions;[45] otherwise, the trusts themselves are taxed.[46] Thus, it is hard to know whether the better result would be to apply the conduit theory to trusts, and treat them like a partnership, or apply the taxable entity theory, or attempt to vary the treaty consequences with domestic law. The third solution would probably be best for United States trusts.

None of the above is specified in most United States tax conventions.[47] United States domestic tax regulations have adopted the conduit theory for nonresident beneficiaries of domestic trusts, tying it strictly to the conduit provisions of its domestic law,[48] but operating in different ways for partnerships and trusts.[49] In this respect, the 1967 Convention is superior. The definition of "resident of the United States" states that a person acting as a partner or fiduciary is a resident "only to the extent that the income derived by such person in that capacity is taxed as the income of a resident."[50] Under this definition, the characterization as a resident is taken from the taxable entity. For example, a trust taxable to the beneficiaries under United States domestic law is considered a resident of the United States only to the extent that the beneficiaries thereof are residents. A trust whose income is taxable to the trust will be a resident of the United States if United States domestic tax law considers it a resident trust. It is unfortunate that the same definition is not applied to French residents in the 1967 Convention. Although France avoids the problem of trusts and estates, this would provide some convention language to base "passing-through" characterization from the partners to the partnership. Since France ignores the partnership entity and only imposes tax on the partners, they can reach the same result through use of Article 2 of the new convention, which provides that terms not otherwise defined shall have the same meaning as they have under the domestic tax laws of the contracting states. However, such a solution is less satisfactory than a specific convention provision because of the additional certainty the latter provides for taxpayers. This result, of course, requires the like attribution of any permanent establishment of a partnership to its partners,[51] and a permanent

44. Int. Rev. Code of 1954, §§ 661-63; Chommie § 131, at 323-24.

45. Int. Rev. Code of 1954, §§ 665-68; Chommie § 131, at 324-26.

46. Int. Rev. Code of 1954, §§ 661-63; Chommie § 131, at 323-24.

47. It has been argued that the regulation's result is justified by the context. Foreign Tax ¶ IX/10F.

48. Treas. Reg. § 514.7 (1957).

49. Compare Treas. Reg. § 510.119(a) (1960), with Treas. Reg. § 510.120(c) (1960).

50. 1967 Convention, art. 3(2)(b).

51. See text accompanying notes 144-204 infra. The OECD Draft avoids this problem

establishment of a trust or estate to its beneficiaries. Income tax regulations have long (and incorrectly, in this writer's opinion) been cited against this proposition,[52] but the Treasury has made the attribution[53] and has received both judicial[54] and legislative support.[55]

The new convention creates a problem of double residence for corporations but solves one for individuals. Under the Protocol to the 1945 Convention, a French corporation was defined as a corporation created or organized under the laws of France.[56] Since this is the reciprocal definition of a United States corporation, no corporation could be resident of both countries, as a corporation could not be created or organized under both the law of the United States and France. The new convention retains the same definition of United States corporations[57] but changes the definition of a French corporation to a corporation "which is resident within France for French tax purposes."[58] Technically, however, no corporation is resident within France for French tax purposes. France divides corporations into French corporations and foreign corporations. It appears that the terms "French" and "foreign" designate what the United States would refer to as resident and nonresident corporations.[59] Since a corporation is resident in France for French tax purposes when, and only if, its actual head office is located in France,[60] a corporation organized under the laws of one of the United States having its head office in France is a corporation, and therefore, a resident of both contracting states.[61] Such a corporation would only receive the

by confining the term resident to a person liable to tax in a state by reason of his domicile, residence, or place of management therein. OECD Draft, art. 4(1). Since partnerships are not subject to any tax, this definition peers through to the partners.

52. The regulation that has often been cited is Treas. Reg. § 1.871-8(c) (1964), which reads: "Neither the beneficiary nor the grantor of a trust . . . is deemed to be engaged in trade or business within the United States merely because the trustee is engaged in trade or business within the United States." It has been interpreted to prohibit the attribution of characteristics from a trust to its beneficiaries. This reading overlooks the word "merely", which should indicate that something more will suffice to attribute the trustee's status to the beneficiaries. That additional something is the taxability of trust income, via the conduit principle, to the beneficiaries. In Ed & Jim Fleitz, Inc., 50 T.C. 384 (1968), the tax court took a similar position on the word "merely" appearing in Int. Rev. Code of 1954, § 401(a)(5).

53. E.g., Treas. Reg. § 504.120(c) (1960).

54. W.C. Johnston, 24 T.C. 920 (1955).

55. Int. Rev. Code of 1954, § 875(2).

56. 1945 Convention Protocol, art. III(d),(e).

57. 1967 Convention, art. 2(1)(d)(i).

58. Id., art. 2(1)(d)(ii); Foreign Tax ¶ IX/10E(1).

59. France § 11/2.2a, at 714 n.16.

60. Id. § 11/2.2a, at 713-14.

61. Great Britain provides that a corporation is resident in Britain if it is incorporated and holds directors' meetings there, although its center of management is elsewhere. Swedish

benefits of the nondiscrimination and relief of double taxation articles of new convention.[62]

The OECD Draft solves the problem by the usual continental rule—a corporation is a resident of the country in which its place of effective management is located.[63] This rule is supported by two theories. The first theory is that the tax burden on a corporation should be determined by the substance of its activities rather than its arbitrary choice of a jurisdiction in which to incorporate.[64] Since most countries tax income from sources within their borders even as to nonresident corporations,[65] this argument is not very persuasive as the source of income is sometimes an arbitrary company choice. More persuasive is the fact that, as with an individual, the government of allegiance, to which a corporation renders tax on its world-wide income, should be determined on the basis of substantive activities rather than formalities. A second theory is that a great deal of income is in fact produced by the managerial skill of the place of effective management. Therefore, the country in which that management lies should tax that income. This argument is of dubious validity in view of the common practice of sourcing income other than in accordance with the place of effective management. On the other hand, there is a certain degree of arbitrariness in calling a corporation a resident of the state which issued its charter. This would permit a corporation to pick a country of residence without regard for any substantive connection to that country. However, such a rule has the advantage of clarity and would be easy to apply. It does not require determining which office represents the place of effective management, as the management of a great many corporations is diffused.[66] Either solution, however, is preferable to the current one in trying to avoid dual residence. However, a change of either definition would raise the problem of according

Cent. Ry. v. Thompson, [1925] A.C. 495, 508; Harvard Law School, World Tax Series, Taxation in the United Kingdom § 5/2.2, at 124-25 (1951) [hereinafter cited as United Kingdom]. Contra A. Ehrenzweig & F. Koch, Income Tax Treaties 69 (1950); Great Britain also provides that a corporation is a resident of Great Britain if its center of management is there although it is incorporated elsewhere. De Beers Consol. Mines Ltd. v. Howe, [1906] A.C. 455; A. Ehrenzweig & F. Koch, supra at 68-70; United Kingdom § 5/2.2, at 124.

62. 1967 Convention, art. 22(4)(a).

63. OECD Draft, art. 4(1). In view of United States domestic tax law, it is not surprising that the United States entered a reservation to this paragraph.

64. De Beers Consol. Mines Ltd. v. Howe, [1906] A.C. 455.

65. See, e.g., France § 11/3.4, at 754.

66. This problem does not appear to have arisen much in Europe, perhaps due to the smaller size of European businesses. The possibilities are illustrated by the distinction in French domestic tax law between siege social fictif, the place designated in the charter as the head office, and seige social effectif, the place where effective management is centered. Id. § 11/2.2, at 714.

convention benefits on one basis and taxing world-wide income on another. This can lead to establishing an unintentional tax haven. For example, if the definition of a French corporation were changed to one incorporated in France, a French corporation managed and controlled from Panama would receive convention benefits but would not be subject to French taxation as a resident.[67] As unwarranted exemptions are more of a prevalent problem than possible dual residence, the new convention has properly weighed the considerations[68] in its change of the definition of the term "French corporation."

A recurrent problem under tax conventions has been defining the status of individuals who have substantial contacts with both contracting states. The 1945 Convention evaded the problem by refusing to define the term "resident," thereby incorporating the domestic law of each contracting state to determine whether an individual is resident therein.[69] The new convention provides that where an individual is, under the domestic law of each country, a resident of both countries, he shall be considered a resident of the country in which he maintains his permanent home. If an individual does not maintain a permanent home, he shall be considered a resident of the country in which he has his center of vital interests; or in default thereof, he shall be considered a resident of the country in which he has an habitual abode.[70] If this fails to resolve the deadlock, provision is made for mandatory agreement between the contracting states.[71] The new convention defines permanent home as "the place in which an individual dwells with his family."[72] This definition raises more questions than it solves problems. Must a bachelor live with his parents in order to have a permanent home? What of a man separated from his wife and children?[73] The requirement that the individual dwell with his family adds only confusion. The definition of permanent home may be of help in determining a person's principal permanent place of residence in the normal case, but cases of double residence only arise because the fact pattern is abnormal. Family ques-

67. Foreign Tax ¶ IX/10D(4).

68. United States officials of long experience report never having problems involving double residence of corporations.

69. Foreign Tax ¶ IX/7A(2)-7B(2); see Treas. Reg., § 514-104 (1946). Deference to domestic law is specific in article 2(2) of the 1967 Convention. A United States resident is one who is more than a transient or sojourner. Treas. Reg. § 1.871-2(b) (1960).

70. 1967 Convention, art. 3(3).

71. Id.

72. Id.

73. A better example might be Joseph P. Kennedy who, while Chairman of the Securities and Exchange Commission, rented an estate near Washington, D.C. in which his wife and children never lived as they resided in Palm Beach and Hyannisport. R. Whalen, The Founding Father 156, 161-62 (1964).

tions aside, it seems that an individual need not own property to have a permanent home. Commentary on the OECD Draft indicates that the home need only be "available to him."[74] However, it must be available on a long-term or long-continued lease; otherwise, it will lack the requisite quality of permanency.[75]

The concept of permanent home should not be confused with the French doctrine of principal residence. Under French domestic law, domicile is used to determine whether an individual is subject to tax on his world-wide income.[76] An alien can only be domiciled in France if he: (1) has his center of vital interests in France, or (2) has his principal residence in France for more than five years.[77] Both the United States and France manifested their intention in the 1967 Convention to distinguish the two terms by using different French terminology.[78] The difference in meaning is striking. Under French domestic law, an alien may have a principal residence in France without an establishment of his own; he may live with friends or in a hotel.[79] The significant question is the amount of time spent in France during a period compared with the amount of time spent in other places. The concept of permanent home would seem to require a residence that is owned or leased. However, a hotel room maintained with some degree of permanency would certainly qualify. The key to the definition is the relative continuity of maintainance of the facility.

The permanent home distinction will rarely resolve the question of dual residence. Most people with dual residence are likely to have permanent homes in both contracting states. If this were the case, then it would be necessary to consider the center of vital interests test.[80]

The concept of the center of vital interests has no meaning in United States domestic law, but it is a term familiar to French tax practitioners in defining domicile under French law. In France, an individual has his

74. OECD Draft Commentary 68. Interpretations of the OECD Draft are useful in construing provisions modeled after it. Indeed, this is one of its principal functions. Cf. Hearings 14.

75. However, the Internal Revenue Service has espoused a floating crap game theory of permanency when defining permanent establishment. Compare Rev. Rul. 165, 1956-1 Cum. Bull. 849, with Rev. Rul. 249, 1960-2 Cum. Bull. 264.

76. However, an alien is not taxed in France on his foreign income if such income is taxed by the country of which he is a citizen as part of a tax on his world-wide income. France § 11/1.2b.

77. Id. § 11/2.1a.

78. Principal residence in French is "sejour principal," and permanent home in the French language version of the new convention is "un foyer d'habitation permanent." 1967 Convention, art. 3(3) (French language version).

79. France § 11/2.1a, at 711.

80. See text accompanying note 70 supra.

center of vital interests in the place where the major part of his economic activities are carried out.[81] If an alien carries on no economic activities, the location of the main portion of his wealth determines his center of vital interests.[82] Although the French tax administration has contended that the location of intangible assets is the place of management of that wealth,[83] the Council of State has recently ruled that an alien who carried on no business in France and whose wealth consisted of foreign securities on deposit in a foreign bank did not have his center of vital interests in France, although he managed the securities himself from Paris.[84] Therefore, the physical location of the securities, rather than the place from which the portfolio is managed, determines the center of vital interests.

The French concept of vital interests and the one used in the new convention are not the same. The provision found in the new convention is taken from the OECD Draft, and the Commentary accompanying the Draft indicates that the center of vital interests is the country "with which his personal and economic interests are closest."[85] This implies a broader scope than the French concept, which is confined solely to economic interests, and requires a determination of the total context of the individual's interests, both personal and economic. The new convention reinforces this interpretation.[86]

The third test for resolving cases of dual residence is the state in which the individual maintains an habitual abode.[87] If the preceding tests are unable to resolve the controversy, it is unlikely that the habitual abode test will be of any help. Any individual with a permanent home in both contracting states or with a situation that precludes determining which of two contracting states is the center of his vital interests is likely to have an habitual abode in both contracting states. On the other hand, it is conceivable that an individual with a permanent home in neither contracting state and for whom neither contracting state is the center of his vital interests may have an habitual abode in only one of the contracting states. The terms "permanent home" and "habitual

81. France § 11/2.1a, at 711.

82. Id. § 11/2.1a, at 710.

83. Id.

84. Id. It should be noted that although European judicial decisions are not binding on other courts or even on the same court in the future, there is an exception in the field of French administrative law, which includes tax law. In this field, the law is developed through the decisions of the Council of State in a form analogous to the common law in Anglo-Saxon jurisdictions. Thus, a decision of the Council of State is likely to set a binding precedent. Id. § 1/3.4e.

85. OECD Draft, art. 4(2)(a).

86. OECD Draft Commentary 68.

87. 1967 Convention, art. 3(3).

abode" are quite close to each other in practice. Perhaps the chief distinction is that an individual who habitually lives in a country, but lives at no place in that country long enough to have the requisite quality of permanency, would have an habitual abode in that country.

Finally, if none of the above tests are able to resolve the problem of dual residence, the competent authorities of the contracting states shall settle the question by mutual agreement.[88] This provision seems to be mandatory on the competent authorities, but the procedure that an individual who is charged with having a dual residence would follow, in forcing the competent authorities to agree on his residence, is not clear or imaginable. The addition of the mandatory phrase to the residence article does not supplement the mutual agreement procedure set forth in Article 25 of the new convention. It may have been inserted in the article dealing with residence to remind the competent authorities of the extreme problems faced by an individual who is deemed to be a dual resident in order to urge them to find a solution.

Despite the problems described above, the adoption of criteria for resolving dual residence problems is a step toward rationalizing the determination of residency.[89] For the United States, dual residency of individuals has not been an important problem, but its existence can result in double taxation of the individual and should, if possible, be eliminated. However, the new convention does not deal with the problem of eliminating the occasional problem that occurs where a person is taxed on his world-wide income by neither contracting state even though his only contacts are with the two states party to the convention. This problem usually occurs because the tax systems of the two states have exemptions that do not completely mesh. This situation was exemplified in the case of *David E. Rose*,[90] where the taxpayer, a United States citizen, was exempt from United States tax[91] because he was not a United States resident. His exemption from British tax resulted from the type of income he received and the method of payment.[92] In this case, Rose was certainly a British resident.[93] The problem was caused by the unilateral effort of each country to relieve international double taxation by the exemption method, which sometimes leads to nontaxability in both countries. The type of situation that occurred in *Rose* could not

88. Id., art. 3(3).

89. Accord, Kragen 309-10.

90. 16 T.C. 232 (1951).

91. This case was decided under the Int. Rev. Code of 1939, ch. 619, § 148(a), 56 Stat. 841 (now Int. Rev. Code of 1954, § 911(9)(1)).

92. 16 T.C. at 233.

93. Id. at 238. See, e.g., Miesegaes v. Comm'rs, 37 Tax Cas. 493 (C.A. 1957); Fleming v. Wilkerson, 10 Tax Cas. 416 (C.A. 1925).

arise under the 1967 Convention since France taxes the world-wide income of its residents, and supplies no unilateral relief by exemption or credit.[94]

III. Business Profits

The 1967 Convention does not change the general rules for the taxation of business profits. Under both the old and new conventions, business profits derived by a resident of one contracting state from sources within the other contracting state are taxed only to the extent that they are attributable to a permanent establishment of the resident located in the source state.[95]

A. *Shipping and Aircraft*

Income from the international operation by a resident of one country of ships and aircraft registered in that country is taxable only in the country of residence.[96] The requirement that the ship or aircraft be registered in the country of residence does not constitute a change from the 1945 Convention.[97] It would, for example, prevent United States residents (or French residents) who register their ships in Liberia from receiving the benefits of the new convention.[98] The inclusion of registry requirements was at the insistence of the United States. It is part of the policy aimed at encouraging United States registry in order to have aircraft and vessels available in case of emergency, such as was experienced in World War II. In addition, denying the tax benefit may partially offset the economic advantages of foreign registry, namely, not being

94. France § 11/1.2.

95. 1967 Convention, arts. 6(1) & 22(2)(a); 1945 Convention, art. 3; Carroll, Will Franco-American Tax Treaty Aid Business with France?, 23 Taxes 228, 230 (1945) [hereinafter cited as Carroll].

96. 1967 Convention, art. 7.

97. 1945 Convention, art. 6. This provision liberalized the prior convention which applied only to trips between France and the United States. Carroll 231, 233.

98. In some United States tax conventions, there is no requirement that the registry be in the country of which the owner is a resident. Convention with Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, June 13, 1949, art. V., [1951] 2 U.S.T. 2323, T.I.A.S. No. 2357 (effective Dec. 11, 1951), 2 CCH Tax Treaties ¶ 6103 (1969) [hereinafter cited as Norway Convention], as modified, Protocol to the Convention with Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 11, 1951, [1951] 2 U.S.T. 2351, T.I.A.S. No. 2357 (effective Jan. 1, 1951) [hereinafter cited as Norway Convention Protocol]. However, the recent tax conventions have all required it. See, e.g., Convention with the Grand Duchy of Luxembourg with Respect to Taxes on Income and Property, Dec. 18, 1962, art. V, [1964] 2 U.S.T. 2355, T.I.A.S. No. 5726 (effective Jan. 1, 1964), 1 CCH Tax Treaties ¶ 5302 (1965) [hereinafter cited as Luxembourg Convention].

subject to United States labor laws or having to deal with domestic maritime unions. It is doubtful that the tax loss by lack of convention benefits is significant enough to alter the decisions of business enterprises as to registration of their vessels. The wage savings would seem to greatly outweigh any possible tax loss. The registry requirement of the new convention is a deviation from the OECD Draft, which simply provides that shipping and aircraft profits should be taxable only in the state in which the place of effective management is situated.[99]

The principal justification for the exemption of shipping and aircraft profits is the difficulty of allocating profits between the two states, one of which is the state of departure and the other the state of arrival. The passenger traffic in both directions will be the same, since most people take round trips. Although it is possible to attempt to allocate profits on the basis of the nationality or residence of the passengers, the departure point of the majority of the cargo, or the country in which the ticket is sold, it is usually not worth the trouble of allocation where both countries have strong shipping and aircraft organizations.[100]

The definition of profits from the operation of ships or aircraft in international traffic is very broad. It includes profits which, because of their close connection with transport profits, are difficult to separate from transport profits.[101] It would include profits from a flight within a country if that is a continuation of an international flight.[102] This is so regardless of the fact that a passenger may join the plane only for a domestic flight. However, Air France does not currently take passengers from point to point within the United States, nor do any United States carriers do so in France.[103] Other profits included within the term shipping or aircraft profits include the fully equipped, manned, and supplied charter of a boat or aircraft, the sale of passage tickets on behalf of other enterprises, operation of a bus service connecting a town with its

99. OECD Draft, art. 8. The United States did not enter a reservation to this article. OECD Draft Commentary 68.

100. Since shipping and aircraft agreements are also in effect with countries having comparatively small sea or air establishments, e.g., Agreement with Colombia with Respect to Relief from Double Taxation on Earnings from Operation of Ships and Aircraft, Aug. 1, 1961, [1961] 3 U.S.T. 3141, T.I.A.S. No. 4916 (effective Dec. 11, 1961), it is apparent that the amount of passengers or cargo carried by the enterprises of the respective countries is irrelevant to this determination.

101. OECD Draft Commentary 90.

102. Id.

103. Letter from John C. Pirie, Vice President and General Counsel, Pan American World Airways, to Herbert I. Lazerow, Sept. 16, 1969; Letter from Stephen Mackevicius, Legal Services Manager, Air France, to Herbert I. Lazerow, Sept. 4, 1969; Letter from Paul M. Ostergard, Attorney, Trans World Airlines, Inc., to Herbert I. Lazerow, Sept. 22, 1969.

airport, and advertising and commercial propaganda profits related to the shipping and aircraft business.[104] On the other hand, the term does not include clearly separate activities such as the maintenance of a hotel (except as an overnight waiting room for passengers), profits from ship building yards, or other distinctly separate types of enterprises.[105] Thus, the profits from a package tour to France in a United States airline that includes stays in various airline-owned downtown hotels would have to be allocated between the cost of transportation and the cost of the hotel rooms.[106] This provision may become troublesome to apply with the advent of conglomerates which own both airlines and hotels.[107]

The shipping and aircraft provision deviates from the OECD Draft in another fashion. The OECD Draft applies the same rule to income from the operation of boats on inland waterways as is applied to ships in international commerce. This provision is found in none of the United States tax conventions, probably because coastal trade has been reserved to vessels built and registered under the laws of the United States and owned by United States citizens.[108]

B. *Definition of Business Profits*

The definition of business profits in the 1967 Convention is one of the most important changes from the 1945 Convention. The inclusion in the new definition of "income derived from manufacturing, mercantile, agricultural, fishing, or mining activities, from the operation of ships or aircraft, from the furnishing of personal services . . . ." and from insurance activities is not exceptional.[109] All of the above are usually considered the active conduct of a trade of business.[110] They were no doubt included within the term "business profits" under the old convention, al-

104. OECD Draft Commentary 90.

105. Id. at 91.

106. Id.

107. Pan American Airways owns a hotel in Paris and another in Tahiti through a wholly-owned subsidiary. Letter from John C. Pirie, Vice President and General Counsel, Pan American World Airways, to Herbert I. Lazerow, Sept. 4, 1969. Trans World Airlines has interests in several French hotels through its subsidiary, Hilton International. Letter from Paul M. Ostergard, Attorney, Trans World Airlines, Inc., to Herbert I. Lazerow, Sept. 22, 1969. Quaere whether subsidiary profits are included or allocated?

108. Central Vt. Transp. Co. v. Durning, 294 U.S. 33 (1935); 46 U.S.C. § 883 (Supp. V, 1970). Whether a similar prohibition exists in France is unknown to this author. If not, then the usual rule for business profits would apply. If a United States enterprise engaged in inland transport in France and had a permanent establishment there, the profits attributable to that permanent establishment would be taxed by France. It is possible for a shipping or transport enterprise to operate in one country without having a permanent establishment there.

109. 1967 Convention, art. 6(5).

110. Hearings 26.

though the definition found therein is exclusionary—it simply enunciated types of income that were not business profits.[111] However, the inclusion in business profits of income from rents or royalties derived from motion picture films and films or tapes of radio or television broadcasts is new.[112] In the old convention, these "cultural" royalties were exempt from tax in the source country as royalties.[113] The film industry, one of the strongest lobbying groups behind tax convention negotiation, wanted royalties from the showing of motion pictures to be included within the definition of business profits.[114] This desire was based on the fact that the rate for royalties may vary as countries discover that royalties received by their residents from activities conducted in the United States are at a continual deficit to the royalties received by residents of the United States from activities conducted in those countries.[115] Since current techniques of marketing motion pictures do not require a permanent establishment in the country in which the pictures are shown, the submergence of motion picture royalties within the broad category of taxation of business profits will insulate movie royalties from tax in the source country.

Movie royalties are a particularly sore point in United States-French relations. In the early 1950's controversy arose between United States companies receiving industrial and motion picture royalties from France and the French tax administration.[116] France insisted on imposing twice the taxes of the film "Chiffre d'Affaires" on the payment of movie royalties from French exhibitors to United States picture owners.[117] The United States companies were operating either through French subsidiaries, which collected the royalty fees from the French exhibitors and forwarded them to the United States company, or through French branches which did the same. Under French domestic law, royalties derived from the exhibition of films in France are considered to be from French sources and are subject to the tax on services. Thus, the first tax on services was paid when the French exhibitor forwarded the royalty to the French subsidiary or French branch of the United States distributing company. A second tax on services was levied when the French subsidiary

111. 1945 Convention, art. 3. The OECD Draft takes a third approach by failing to define the term. OECD Draft, art. 7.

112. 1967 Convention, art. 6(5).

113. 1945 Convention, art. 7.

114. Hearings 15.

115. See text accompanying notes 322-31 infra.

116. S. Exec. Doc. J, 84th Cong., 2d Sess. 18-19 (1956).

117. These taxes were the production tax, the transaction tax, and the local additional tax, which amounted in total to about 9 per cent of the gross royalty payments. By reforms instituted in 1954, these taxes were changed to the tax on services, and imposed at the same rate. Id. at 21; France § 14/3.1.

or branch forwarded the royalty to the United States distributing company.[118] The United States made elimination of this double taxation and settlement of past disputes between the United States motion picture industry and the French taxing authority a prerequisite to completion of an amendatory convention to the 1945 Convention in 1956.[119] The agreement worked out by the motion picture industry and the French tax administration provided that where the United States company operates through a branch in France which is a permanent establishment or operates without a permanent establishment in France, the tax on services would be applied only on the payment of royalties from the exhibitor to the collector of the royalties in France. No tax on services would be imposed on the remission of the royalties to the United States.[120] The incorporation of rentals from motion pictures within the definition of business profits in the 1967 Convention enables the motion picture distributors to combine an advantageous tax provision for the tax on services with one that excludes income taxation of business profits by having no permanent establishment in France.[121] The United States will probably press for such a provision in negotiations concerning future tax conventions.

The rental of tangible personal property is a second change from the 1945 Convention definition of business profits. This type of income was specifically excluded from the definition of business profits[122] in the old convention, so its inclusion in business profits is new in the 1967 Convention.[123] The position of these rentals had been puzzling. There was no reference to the taxation of these items elsewhere in the old convention and its legislative history provided that items not specifically treated in other articles would be taxed under the domestic law of each country.[124] French domestic law would include income from the rental of personal property within the heading of business income[125] which, if it is from business activity in France, is taxed to nonresident aliens and foreign corporations.[126] The United States also taxed this rental income to nonresident aliens and foreign corporations, since it is United

118. S. Exec. Doc. J, 84th Cong., 2d Sess. 18-19 (1956).

119. Id. at 4.

120. For a complete discussion of the agreements, see id. at 15-34.

121. Although the documents which rely on the old convention expired, the French delegation assured the United States delegation that the abrogation "would not entail any important tax consequences." S. Exec. Doc. N, 90th Cong., 1st Sess. 19 (1967).

122. 1945 Convention, art. 3(d).

123. 1967 Convention, art. 6(5).

124. S. Exec. Rep. No. 7, 76th Cong., 3d Sess. 9-10 (1940).

125. France § 7/1.1b.

126. Id. § 11/3.3.

States source income.[127] If the income was not derived through a trade or business carried on in the United States, it was taxed at the rate of 30 percent or the normal rate, whichever was greater.[128] Therefore, the old convention deprived income from the rental of tangible personalty of the benefits of both investment income and business profits. Thus, the inclusion in the new convention of this item in business profits is the most sensible treatment and comports to the domestic law of both contracting states. It wil result in the taxation of such rental income in the source country only when it is effectively connected with a permanent establishment.

It can be argued that income from the rental of tangible personalty is only business income when it is done on a large scale basis, such as the rental of automobiles, copying machines, and computers. The rental by an individual of one, or a small number, of objects is more like investment income or the rental of real property. In the United States, there exists the phenomenon of "investment credit" leases, where wealthy individuals buy airlines, railroad cars, and similar property, financing them to 80 percent of the cost with insurance companies, and leasing them to the user. No such schemes have appeared internationally for several reasons. Among the reasons are that the arrangement might be subject to the Interest Equalization Tax[129] or Foreign Direct Investment Regulations.[130] For whatever reason, there appears to be no known "investment" rentals of tangible personalty abroad, which probably explains the simplicity of the provision in the new convention.

Under the new convention, the business profits of a permanent establishment are to be computed as though it were an independent entity dealing at arm's length with its home office.[131] This provision is completely reworked from the old convention, where the authorities had the right to make such corrections in the income declarations as were necessary to demonstrate the exact profits.[132] However, there is no change in substance between the two conventions.

The new convention specifically allows expenses of earning the income to be deducted from the profits of the permanent establishment. Such

127. Int. Rev. Code of 1954, § 871(a)(1).

128. Int. Rev. Code of 1954, ch. 1, § 871(a)(1), (b)(1), 68A Stat. 278-79 (now Int. Rev. Code of 1954, § 871(a)(1), (b)(1)).

129. Int. Rev. Code of 1954, §§ 4911-20.

130. 3 C.F.R. § 437 (1970), promulgated pursuant to Exec. Order No. 11,387, 33 Fed. Reg. 47 (Jan. 3, 1968). See Lancaster, The Foreign Direct Investment Regulations: A Look at Ad Hoc Rulemaking, 55 Va. L. Rev. 83, 115-17 (1969).

131. 1967 Convention, art. 6(2).

132. 1945 Convention, art. 4.

expenses include appropriate shares of executive and general administrative expenses, regardless of the place in which they are incurred.[133]

These allocation provisions have been criticized as being too indefinite to be of much value.[134] It is true that they do not constitute a complete allocation system, but they are a first step toward a more comprehensive system. The United States domestic system is only comprehensive with respect to certain types of income.[135] Parts of it have, however, been used informally under this provision by foreign governments, thereby creating a common practice in international allocation.[136]

Finally, there is specifically excluded from the definition of business profits any amounts arising from the purchase of goods or merchandise by the permanent establishment or the home office for the account of either party.[137] Some countries consider the purchase of goods within the country and their transportation out of the country as income from sources within that country and, if a permanent establishment otherwise exists, will tax that income to it.[138] Although there has never been any problem in this regard with France, French law does provide that in case of a buying office in France, where the income may not be readily ascertained from its books or records, the office will be taxed "on the basis of the income that would have been earned by an independent firm rendering a similar service."[139] With the strength of the United States concept of realization as a prerequisite to the recognition of any income, it is beneficial to include such a provision in the income tax coventions of the United States. In addition, it constitutes a source rule of sorts which will encourage uniformity in taxation between the two nations.[140]

C. *Definition of Permanent Establishment*

The definition of permanent establishment has been modernized to conform to recent United States tax conventions and the provisions of the OECD Draft.[141] The new convention makes substantial changes in the definition or permanent establishment where a party deals through

133. 1967 Convention, art. 6(3).

134. Owens, United States Income Tax Treaties: Their Role in Relieving Double Taxation, 17 Rutgers L. Rev. 428, 440-41 (1963) [hereinafter cited as Owens].

135. Treas. Reg. §§ 1.482-1 to -2 (1968).

136. Foreign governments are, however, unwilling to accept the many "safe harbors" in those regulations.

137. 1967 Convention, art. 6(4).

138. One example is India. Harvard Law School, World Tax Series, Taxation in India § 11/1.2b (1960).

139. France § 11/3.6b, at 763.

140. Owens 440.

141. OECD Draft, art. 5.

an agent, is in the insurance business, or is in the construction or assembly business. Another change in the definition is the exclusion of certain types of fixed places of business from the definition. It also resolves ambiguities in the OECD Draft. The new convention permits substantially greater economic penetration before a permanent establishment is found.[142]

The function of the concept of permanent establishment is to exclude an enterprise from taxation in another country unless it has sufficient economic penetration to justify the expense and trouble of imposing that country's tax upon it. Under the old convention, the required degree of penetration was achieved whenever the enterprise had a fixed place of business in the source country.[143] There followed an enumeration of things that were commonly considered to be a fixed place of business such as branches, plantations, factories, workshops, stores, offices, agencies, warehouses, mines and oil wells.[144] The same definition is carried over into the new convention with the addition of a seat of management as a fixed place of business.[145] One is forced to speculate about the kind of business that would have a seat of management abroad, but no office.[146] The source of this provision is the OECD Draft, which provides that a place of management is a permanent establishment.[147] When a similar provision was incorporated in the United States-Luxembourg income tax convention,[148] an exchange of letters interpreted it to require a continuous place of management,[149] and excluded from the scope of management,

142. See Tillinghast 432.

143. But see S. Exec. Doc. J, 84th Cong., 2d Sess. 21 (1956), which states that a branch without power to negotiate and conclude contracts is not a permanent establishment. This is inconsistent with 1945 Convention Protocol, art. III(a) which provided: "The term 'permanent establishment' includes branches . . . and other fixed places of business . . . ."

144. 1945 Convention Protocol, art. III(a). At that time there was no definition of "branch" in the United States domestic law, but such a definition did exist when the new convention was being negotiated. Treas. Reg. § 1.963-1(f)(4)(i) (1964). It is doubtful that either country considered this definition when negotiating the new convention.

145. 1967 Convention, art. 4(2).

146. This was the intention of the OECD Draft. OECD Draft Commentary 72. Foreign Tax ¶ IX/12F(1)(a), suggests it was intended to strike at the use of residential property, either a home or hotel, for management decisions. But this would seem to render the residence an office by definition, "the directing headquarters of an enterprise or organization," Webster's Third New International Dictionary 1567 (1967).

147. OECD Draft, art. 5(2)(a).

148. Luxembourg Convention, art. II(1)(f)(ii)(A).

149. S. Exec. Rep. No. 10, 88th Cong., 2d Sess. 41-44 (1964). Similar commentary is found in the memorandum of understanding appended to the German Convention, providing that a hotel room or similar temporary place will not be a place of management. Hearings on S. Exec. Doc. G and S. Exec. Doc. I before the Subcomm. on the Convention with the Federal Republic of Germany on Double Taxation of the Senate Comm. on Foreign Relations, 89th Cong., 1st Sess. 25 (1965) [hereinafter cited as German Hearings].

decisions of a technical nature.[150] The use of the term "seat" instead of "place" seems to be an attempt to imply a requirement of continuity of management. It can also be assumed that the technical exclusion would apply to the new convention because of a presumption of uniformity of interpretation of similar provisions.

Under the domestic tax law of France, a place of management does not constitute a permanent establishment.[151] Therefore, there is less danger that occasional use by the parent's officers of a subsidiary's offices would constitute a permanent establishment. Provisions added to United States domestic law by the Foreign Investors Tax Act defined an office or other fixed place of business with some specificity,[152] which was further refined by recently proposed regulations.[153] Although it is doubtful that these provisions were considered in drafting the 1967 Convention, they will probably be used where consistent with prior interpretation of similar tax convention clauses.

Even though a place of business may constitute a fixed place of business (and thus a permanent establishment under normal circumstances), if it is used only for certain activities the fixed place of business will not be considered a permanent establishment. These activities fall into four categories.[154] The first category is the storage, display, or delivery of goods belonging to the resident.[155] The second is the maintenance of goods belonging to the resident for the purpose of processing by another. The purchase of goods for the account of the resident is the third category.[156] The fourth category is collection or supply of information, advertising, scientific research, or activities of a preparatory nature for the resident.[157] The new convention makes it clear that a resident may engage in all of these activities at a fixed place of business, without it being defined as a permanent establishment.[158]

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150. Secretary Surrey added the technical exclusion in his testimony on the new convention. German Hearings 21.

151. See France § 11/3.5. Unlike France, under German domestic tax law a place of management constitutes a permanent establishment. Tillinghast 431-32.

152. Int. Rev. Code of 1954, § 864(c)(5).

153. Proposed Treas. Reg. § 1.864-7, 34 Fed. Reg. 1030, 1038 (1969).

154. 1967 Convention, art. 4(3).

155. Id. art. 4(3)(a). Drawing the line between these activities and selling may be quite difficult.

156. The 1945 Convention expressly included purchasing offices within the definition of permanent establishment. 1945 Convention Protocol, art. III(a).

157. 1967 Convention, art. 4(3). The exemption for preparatory activities applies only to activities to forward the enterprise's work, not to activities that are sold to others. OECD Draft Commentary 74-75. In the 1920's, Canada tried to tax income from mail sales derived from Canadian advertising. Carroll, International Tax Law, 2 Int'l Law. 692, 700 (1968) [hereinafter cited as International Tax Law].

158. 1967 Convention, art. 4(3), clarifying an ambiguity in the OECD Draft, art. 5(3).

The above activities are excluded from the scope of permanent establishment because they are all relatively minor or preparatory to the earning of income.[159] In the case of preparatory work, the activities are so far in advance of the realization of profits as to not call for characterization of the enterprise as a permanent establishment.[160] With purchases, the exclusion of a purchasing office from permanent establishment is a counterpart to the exclusion from business profits of income from the purchase of goods.[161] In the other cases, the activities may be carried on through a fixed place of business in such a small degree as to make it unwise to tax enterprise's business profits in the source country because of its limited penetration. The amount of income likely to be derived does not justify the tax harrassment to the enterprise. The theory seems to be that the sale is the crucial income-producing item. The finding of a permanent establishment cannot, however, be defeated by requiring acceptance of the sales contract at the home office.[162] This would elevate form over substance to an intolerable degree. It also ignores the concept of the complete cycle in French law. A foreign enterprise with no contacts in France other than its carrying on a complete commercial cycle is taxed on its profits from that cycle.[163] This provision, combined with the substance over form argument familiar to United States tax lawyers,[164] might well rule out a combination of otherwise permitted activities. Under French domestic law, the complete commercial cycle is the performance of all activities necessary for earning the profit within the jurisdiction.[165] Where the enterprise purchased goods in France, had them processed in France under contract with an independent party, had them stored and displayed in France, and took orders in France subject to the approval of the home office in the United States, this should be considered so great an activity within France as to constitute the branch

The United States had been inclined to this view, subject to contrary interpretation by the OECD. S. Exec. Rep. No. 10, 88th Cong., 2d Sess. 15, 64 (1964).

159. See OECD Draft Commentary 74.

160. However, there has been some unhappiness in European circles at the extensive activities of some American propaganda offices. See Kragen 314.

161. See text accompanying notes 127-40 supra. But cf. the old convention where purchasing income is not business profits, 1945 Convention, art. 3, but a purchasing office was a permanent establishment, 1945 Convention Protocol, art. III(a).

162. Tillinghast 432-33; see Rev. Rul. 31, 1962-1 Cum. Bull. 367 (similar interpretation of the United Kingdom Convention). There is language supporting both sides in the OECD Draft Commentary. OECD Draft Commentary 75.

163. France § 11/3.5d; Taxation of Branches in France, 2 Eur. Taxation 103, 106 (1962). Likewise, income from the performance by a French enterprise of a complete commercial cycle outside France is exempt from French tax. France § 11/2.4d.

164. See, e.g., Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929).

165. France § 11/3.5d. Contra, Taxation of Branches in France, 2 Eur. Taxation 103, 106 (1962) and Taxation of Branches in France, 8 Eur. Taxation 167 (1968), which require that the complete cycle be carried on habitually, rather than occasionally.

as a permanent establishment.[166] Of course, the general rule of French law, that treaties are superior to domestic law, would ordinarily preclude the finding of a permanent establishment.[167] But where the substance is the same as a permanent establishment, except for the requirement of final approval by the home office, the substance of the arrangement should govern (particularly when the likelihood of home office disapproval is minimal). This ordinary tendency to prefer substance over form is heightened by the finding of a complete commercial cycle.

Where there is less of a complete business cycle, such as in a case where goods are purchased or manufactured in the United States with the goods being displayed and the orders taken in France, the reinforcing effect of the complete commercial cycle disappears, and the more difficult question arises of whether substance over form is sufficient, by itself, to overrule the specific convention provision permitting these activities. Although each case will probably be decided on its own facts, one suspects that where the branch is making sales in France, with approval of the home office being given as a matter of course, the branch will be considered to have exceeded its display function and will constitute a permanent establishment.

The exclusionary provisions are less important today, since the enterprise is only taxed in the source country on profits attributable to or effectively connected with the permanent establishment. Under the old convention, the presence of a permanent establishment resulted in all earnings being taxed in the source country.[168]

Under the old convention, where there was no fixed place of business, but the enterprise dealt through an agent established in the United States,[169] sufficient penetration existed to constitute a permanent establishment when the agent had general authority to negotiate and conclude contracts, or maintained a stock of merchandise from which he regularly filled orders.[170] However, operation through a bona fide broker or commission agent was excluded.[171] This exclusion was justified by the

166. Tillinghast 433.

167. France § 11/4.5.

168. 1945 Convention, arts. 3, 7 & 11.

169. The transitory presence of such an agent is insufficient; he must be established here. Foreign Tax ¶ IX/12G(1)(b). This casts doubt on the correctness of Rev. Rul. 249, 1960-2 Cum. Bull. 264, which provided that the federal government could withhold income of a transitory agent in the absence of definite information.

170. 1945 Convention Protocol, art. III(a). For construction thereof, see Foreign Tax ¶ IX/12G(2).

171. The 1967 Convention adds a requirement that the agent must act in the ordinary course of his business to maintain the exemption. Compare 1967 Convention, art. 4(5), with 1945 Convention Protocol, art. III(a). The language probably adds little of substance to the former requirement.

rationale that operation through an independent party usually indicated a relatively small operation that had not achieved sufficient economic penetration within the source country.[172] Practicality in administration also supported this exclusion. Profit would be difficult to determine, since the agent only knew the gross sales consummated for the principal.[173] The new convention eliminates from the concept of permanent establishment the agent who maintains a stock of goods from which orders are regularly filled.[174] Such a change follows logically from the exclusion from permanent establishment of fixed places of business devoted to the display, storage, or delivery of goods.[175]

Under the old convention, the agent need only have possessed authority to have constituted a permanent establishment.[176] The new convention requires the habitual exercise of that authority,[177] thereby changing the determination from one of theoretical power to one of actual exercise of power. This is an easier determination to make. The type of authority necessary to constitute a permanent establishment has also changed. The old convention required general authority to negotiate and conclude contracts.[178] The new convention calls only for authority to conclude contracts in the name of the principal. This provision is adopted from Article 5(4) of the OECD Draft, which reasons that an agency with power to bind the foreign enterprise to contracts is a sufficient economic penetration of the country to constitute a permanent establishment.[179]

Another change from the old convention with regard to agency concerns an agent who has, and habitually exercises, authority to enter into contracts on behalf of the enterprise. In the new convention, such an agent will not constitute a permanent establishment if the authority is limited to the purchase of goods for the enterprise.[180] This is analogous to the provision excepting from the definition of a permanant establishment a fixed place of business devoted solely to the purchase of goods.[181]

172. However, Great Britain, shortly after World War I, imposed a tax when sales through an independent agent became sufficiently repetitive to constitute trading. Carroll 700. Opposition to this practice resulted in the general shape of present definitions of permanent establishment. L.N. Doc. C. 562.M.178.1928. 2, at 12 (1928). For a more precise discussion of the independent agent requirement, see Foreign Tax ¶ IX/12G(4)-(6); Short, Permanent Establishment and Agencies, 11 Can. Tax J. 387 (1963).

173. Carroll 330.

174. 1967 Convention, arts. 4(3)(b) & 4(4).

175. Id., art. 4(3)(a), (b); cf. OECD Draft Commentary 76.

176. 1945 Convention Protocol, art. III(a).

177. 1967 Convention, art. 4(4)(a).

178. For a definition of general authority, see Foreign Tax ¶ IX/12G(1)(c).

179. OECD Draft Commentary 75.

180. 1967 Convention, art. 4(4)(a).

181. See text accompanying note 156 supra.

If such a fixed place of business is not a permanent establishment, an agency that only purchases goods should not be either.

As related to agency, the question of whether a foreign concern can eliminate the permanent establishment by requiring approval of all contracts at the home office is the same as that incurred under the specific exceptions from the fixed place of business,[182] and should be solved in the same manner. Though the commentary to the OECD Draft, like the Delphic oracle, points in both directions,[183] the most sensible solution would require an examination of the actual state of affairs. If the agent's essential occupation is selling, and the contracts are approved as submitted in most of the cases, he should be considered to have the requisite authority to constitute a permanent establishment. On the other hand, if the home office often makes substantial modifications of the contract, he should not be so treated.

Another major change from the old convention in the definition of permanent establishment relates to insurance companies. Formerly, an insurance company had a permanent establishment in a state if it received premiums from or insured risks in that state.[184] The result of this definition was to tax all income from insurance of French risks in France,[185] regardless of how small an establishment the insurance company maintained there. Under the new convention, an insurance company that does not have a fixed place of business in a country may have a permanent establishment there if it receives premiums from or insures risks in that territory through a representative other than an independent agent.[186] This permits the company to do some business in the country without having a permanent establishment, as long as its operations are not too extensive. Presumably, the term "independent agent" refers to a commission broker arrangement, not simply an independent contractor in the master-servant sense. This provision is likely to have little effect on United States life insurance companies because these companies do business directly abroad, preferring to operate through subsidiaries, if at all. However, many United States life insurance companies reinsure foreign risks, and would be operating abroad, usually through dependent agents.[187]

182. See text accompanying notes 162-67 supra.

183. OECD Draft Commentary 75.

184. 1945 Convention Protocol, art. III(a).

185. The provision doesn't tax insurance premiums from United States risks of French companies, since United States tax conventions cannot increase United States tax. Under the domestic law of the United States, the source of insurance premium income is the place where the contract is negotiated. Foreign Tax ¶ VI/4D(3).

186. 1967 Convention, art. 4(7).

187. Letter from George Gingold, Attorney, Aetna Life & Casualty Co., to Herbert I. Lazerow, Dec. 24, 1968.

Most domestic insurance operations would have to be considered dependent operations because they are so closely tied to one company. Any agent who places in excess of 80 percent of his policies with one company should not be considered a general commission agent. Where, in addition, the company exercises other controls over the agent, the agent is certainly dependent.[188] Insurance problems have always called forth special attention from France, so this clause is unlikely to appear in other United States tax conventions.

The final change in the definition of permanent establishment provides that a resident of one country has a permanent establishment in the other country if the resident has a person in the other country who maintains substantial equipment or machinery in the source country for a period of at least twelve months.[189] This provision, which expands upon the OECD Draft,[190] does not specify whether a site maintained for less than twelve months is a permanent establishment,[191] but the better interpretation of the provision is that it intends to draw a line that is easy to apply, with a one year cut-off. Whether the provision is a liberalization or tightening of the old rule is difficult to determine. First, it can be argued that sufficient continuity of presence is established for other fixed places and for agency agreements without them persisting for a year. A construction site would normally be a permanent establishment whenever it is as continuous as other types of permanent establishments, but the new convention liberalizes this term by requiring twelve months' dura-

188. A description of the general and district agency as they operate in the United States would be useful here: "The general agency is operated by an individual, usually a successful agent for the company. Many of the large individual and group policies are written by the general agencies. The general agent's status is unclear. He appears to be an agent but he is far from being independent. The company signs the lease for the general agent's office space but he contributes toward the rent in accordance with a predetermined formula. The general agent hires his own subagents but they must be approved by the company. According to his contract with the company the general agent must place all his life, annuity, and accident and health business with the [company], if the company desires to take it.

"The company prefers that the general agent only deal in the lines of insurance carried by the company. If one of his clients desires casualty insurance, or if the company does not approve an application for a life, annuity or accident and health policy, the general agent is free to place the business elsewhere. In the same way the general agent obtains business from other companies' agents.

. . . .

"A large volume in smaller life insurance policies are written by the district agents of the district agencies. These agencies are located in space rented by the company. The agency is managed by an employee of the company and the agents are employees of the company. This is quite apparent when you realize that the district agents have their own union which bargains with the company." Letter from Ronald W. Fox, Attorney, John Hancock Mutual Life Insurance Co., to Herbert I. Lazerow, Dec. 27, 1968.

189. 1967 Convention, art. 4(4)(b).

190. OECD Draft, art. 5(4).

191. OECD Draft Commentary 73.

tion. Second, the construction site provision appears as one of a series of examples of permanent establishments, each of which is a fixed place of business.[192] Third, there is a weak statement in the legislative history of the Canadian Tax Convention,[193] made in support of a provision making any construction site a permanent establishment, that the new language was clarifying and did not change prior law.[194] Finally, it has been suggested[195] that two Revenue Rulings[196] support this view. However, this is a doubtful position, since their express rationale looks elsewhere. In addition, the Canadian situation is sui generis. United States enterprises would often conduct logging operations in Canada during the logging season. These enterprises contended that their operations did not constitute a permanent establishment since they were constantly moving. As soon as the timber in one area was exhausted, the sawmill operations would be moved to a second area. Their operations were seasonal, and the equipment sometimes returned to the United States. The same situation applied to road building and other construction projects.[197] The legislative history of the Canadian Tax Convention should not be considered binding, particularly since the Treasury itself rejected it in the mid-1960's in a dispute with Japan.[198] Nor is the placement of the provision determinative of the argument. Under the new convention, a construction site only constitutes a permanent establishment as a fixed place of business if it exists for more than twelve months,[199] which was not determinative of whether, under the old convention, a construction site of any length was a permanent establishment.

A better way to view the problem would be to first look at the purpose of finding a permanent establishment, which is to determine whether a concern has made sufficient economic penetration of a country to justify taxation there of its business profits derived from that country. In the case of a sales agency operating through a fixed place of business, this requires a continuity of activity, which will generally involve different patrons. Likewise, for an agency, a dependent agent must have authority to negotiate and conclude contracts, implying contact with more than one customer. A construction site differs from these activities in that it is directed toward satisfying the order of one customer—a one-shot deal. There is no dealing with the public in the country. On the other hand,

192. For further development of this argument, see Foreign Tax ¶ IX/12K(2).
193. Canadian Convention Protocol, art. 3(f).
194. S. Exec. Doc. R, 81st Cong., 2d Sess. 8 (1950).
195. Foreign Tax ¶ IX/12F(5).
196. Rev. Rul. 249, 1960-2 Cum. Bull. 264; Rev. Rul. 165, 1956-2 Cum. Bull.
197. S. Exec. Doc. R, 81st Cong., 2d Sess. 8 (1950).
198. S. Exec. Rep. No. 10, 88th Cong., 2d Sess. 67 (1964).
199. 1967 Convention, art. 4(2)(h).

by accepting the given premise, it can be argued that most construction sites are so extensive that the establishment of even one site should be sufficient economic penetration to find a permanent establishment. The conflict between these two arguments can only be resolved by determining whether it is the dealing with the public, or the size of the venture, or a combination of the two, that is controlling. The provisions relating to agencies and exclusions from permanent establishment seem to opt for a dealing with the public rationale.[200]

The difficulties with construction sites can be traced to two conceptual variations. First, a construction site, no matter how small or short of duration, is always fixed in the sense of having a permanent position. It thereby differs sharply from the agency situation. The place of the activities cannot be changed to provide the most advantageous tax consequences. Second, construction is intimately tied to real property, which has always been considered taxable primarily in the source country. This second variation has led to many countries arguing that substantial construction projects should not escape tax at the source.

The twelve month limitation will take care of the annoying case of the employee in the foreign country who supervises the installation of machinery sold by the enterprise.[201] This type of installation site would seldom last more than twelve months. However, if it does, it will run afoul of the provision, and constitute a permanent establishment. This may be considered unjust on the ground that the principal income producer is the sale, which was performed without a permanent establishment. If the installation lasts for more than twelve months, the installation must have produced a significant part of the income. Furthermore, the convenience of having a fixed rule of twelve months outweighs any injustice imposed in individual cases. The advantage of a fixed rule will probably lead to the inclusion of a similar clause in all future tax conventions negotiated by the United States.

The new convention, like all tax conventions, slants its definition of permanent establishment primarily toward the sales organization. The "substantial equipment" provision is the one concession that other types of organizations may have substantial economic penetration in a country without being served by a fixed place of business. For example, a French actor might incorporate in France, and become the employee of that corporation. The corporation would then sign a contract with a producer for the employee's services in a play or film. Under the present provisions, the corporation would have no fixed place of business in the United States, nor would there be other grounds upon which to attach a

200. Foreign Tax ¶ IX/12F(1)(b).

201. Id.

permanent establishment status to it. The corporation would not be taxed on the income from the play, and the actor would be taxed only if he was present in the United States for at least 183 days during the taxable year,[202] and then only on the compensation he personally received. Judicious selection of the date to open the play or of a fiscal year for the actor could result in his presence in the United States for almost a full year without being subject to tax on the remuneration he receives from his corporation. Similar problems exist with respect to the construction, technical, and consulting businesses.[203] In these fields, it is likely that great economic penetration will be accompanied by a fixed place of business. However, this is not the case in the real estate business, where great penetration can be achieved through the use of an independent agent.[204] As real estate profits are fully taxable in the source country, abandonment of the force of attraction doctrine reduces the importance of the decision.

D. *Abandonment of the Force of Attraction Doctrine*

Until 1965, all United States tax conventions made the existence of a permanent establishment in the source country an important difference.[205] A person who had a permanent establishment was taxed by the source country on all investment and business income from the source country. On the other hand, a person without a permanent establishment was not taxed in the source country on business profits, and was entitled to a reduced rate, or an exemption from tax on investment income.[206] Therefore, the determination of the existence of a permanent establishment became crucial. Slight fact differences could result in great differences in

202. 1967 Convention, art. 15(2). It is doubtful that the French rules relating to S.A.'s (French corporations) and S.A.R.L.'s (French limited liability companies) would hinder this. France § 1/3.6.

203. A full discussion of the problems of reaching a just definition of permanent establishment where service organizations are concerned is beyond the scope of this article. The material discussed in text gives a sufficient hint of the problem and its pressing necessity in the entertainment field.

204. Cf. Inez De Amodio, 34 T.C. 894 (1960), aff'd, 299 F.2d 623 (3d Cir. 1962); Foreign Tax ¶ IX/12F(4).

205. For a further discussion of the doctrine, see Foreign Tax ¶ IX/13B.

206. There are two exceptions. Where a construction site constitutes a permanent establishment under the Japanese Convention, only related income is taxed in the source country. Convention with Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, April 16, 1954, art. VI(1)(b), [1955] 1 U.S.T. 149, T.I.A.S. No. 3176, 1 CCH Tax Treaties ¶ 4402 (1965). Under the United Kingdom Convention, royalties are taxed to one with a permanent establishment in the source country only if effectively connected therewith. United Kingdom Convention, art. VIII(3); Tillinghast 420 n.93.

tax consequences. The reason for the rule was to provide an easy method of determining the amount of profits and to avoid artificial allocations.[207]

The United States has finally been persuaded to abandon this "force of attraction" principle. The new convention provides that business profits will be taxed in the source country if they are allocable to a permanent establishment located therein.[208] Investment income is taxable in the source country at the full rate only if it is effectively connected with a permanent establishment in that country.[209] This rule comports with the traditional European point of view. Once jurisdiction to tax is established, the source country can tax the permanent establishment on the income attributable to it.[210] This comports with the way business is in fact transacted, and does not raise artificial fiscal barriers for business enterprises.[211] These alternative methods of taxation are incompatible and, when the United States changed its Internal Revenue Code[212] to encourage foreign investment, it made sense to shift the convention rule to conform to the European view.

This change in convention provisions requires defining the investment income that is effectively connected with a permanent establishment. The same problem has been imported into United States domestic law by the Foreign Investors Act,[213] and into our tax convention law by the recent German Convention Protocol.[214] The Internal Revenue Code provides that in determining whether income is effectively connected with a permanent establishment, one must consider whether the income is derived from assets used in the business[215] or whether the activities of the business were a material factor in the realization of the income.[216] Extensive regulations have been proposed defining these terms,[217] and they will be persuasive but not determinative, in interpreting these terms. Whether such gain was accounted for through the business is a measure that can be used in determining whether these two conditions apply, although failure to so account doesn't negate the presence of

207. OECD Draft Commentary 80-82.

208. The old convention read the same way, 1945 Convention, art. 3, but regulations found all income allocable to the permanent establishment. E.g., Treas. Reg. § 514.105(c) (1957).

209. 1967 Convention, arts. 6(1), 9(3), 10(4), 11(5), 12(2) & (3).

210. See, e.g., France § 11/3.5.

211. OECD Draft Commentary 80-82.

212. Int. Rev. Code of 1954, §§ 861-64, 871-74 & 881-82.

213. See note 5 supra.

214. Protocol Modifying the Convention of July 22, 1954 with Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, Sept. 17, 1965, [1965] 2 U.S.T. 1875, T.I.A.S. No. 5920 (effective Dec. 27, 1965), 1 CCH Tax Treaties ¶ 3025 (1966).

215. Int. Rev. Code of 1954, § 864(c)(2)(A).

216. Id. § 864(c)(2)(B).

217. Prop. Treas. Reg. § 1.864-4(c), 34 Fed. Reg. 1032 (1969).

those factors.[218] The legislative history of the Foreign Investors Act adds some examples. The following will be considered income effectively connected with a permanent establishment: (1) royalties income of a licensing business operated through a permanent establishment; (2) interest income of a financing, banking, or similar business; (3) management of corporate investments where the maintenance of such investment constitutes the principle activity of the corporation; (4) interest on trade accounts receivable; (5) dividends or capital gains on stock of a supplier corporation purchased to assure a ready source of supply; (6) income earned from dividends where an individual purchases stock in a domestic corporation to assure the opportunity of performing personal services in the United States for that corporation; and (7) interest, dividends or gains from the investment of funds on a short term basis which are normally needed as working capital.[219]

The German Convention sources have little to add to this definition in substance, but express it in a different form. Investment income is effectively connected if the asset giving rise to the income is held by the permanent establishment, the asset is held specifically to promote the business activities of the permanent establishment, or the activities of the permanent establishment are a material factor in producing the income.[220] Capital gains, however, are only included under the first two categories.[221] Although it can be argued that the provision is inclusionary and not exclusionary, the failure to specify capital gains where the activities of the permanent establishment are a material factor in producing them is probably intended to exclude those gains from effectively connected income.

These provisions are troublesome to lawyers in the United States. For United States tax purposes, a permanent establishment doesn't "hold" any asset, since all the enterprise's property belongs to the total enterprise. But in Germany, separate books of account must be kept for each branch's transactions and a balance sheet drawn for the branch.[222] This is usually the practice in France also.[223] Any assets appearing on the balance sheet are held by the branch. Presumably, the

218. Int. Rev. Code of 1954, § 864(c)(2). In Europe, this is the traditional starting point, and any deviations from the enterprise's books must be supported by the tax authorities with convincing reasons. France § 11/3.6b.

219. H.R. Rep. No. 1450, 89th Cong. 2d Sess. 57-68 (1966).

220. German Hearings 25.

221. Id.

222. Tillinghast 424.

223. France § 11/3.6b.

German Convention will require United States branches of foreign enterprises to keep separate books.[224]

The most easily identifiable item of effectively connected income is income held specifically to promote the business activities of the permanent establishment. Into this category falls income from employment of working capital, interest on trade receivables,[225] and income from assets purchased to assure a source of supply or purchase of goods or materials of or by the permanent establishment.

A category similar to income from working capital is income derived from insurance company assets deposited as capital or reserves against liability on policies written in the country of the permanent establishment.[226] Without the deposit, the permanent establishment could not write insurance within the jurisdiction, so the deposits are certainly held to promote the business activities of the branch.

A somewhat troublesome area is loans by banks with branches in many countries. Clearly, under the German Convention or United States domestic law, loans made out of funds of the branch bank in the United States are always effectively connected with the permanent establishment, since they constitute income from assets of the branch.[227] More difficult questions are raised when the loan is made by the main office abroad to an habitual customer of the United States branch. Where the loan is arranged by the branch, interest is effectively connected because the activities of the branch were a material factor in earning the income. They would not be effectively connected on the second ground, however.[228] Although assets loaned on the direction of the branch are assets held for use by the branch, they are hardly held *specifically* for such use. Where the loan is made without the assistance of the branch office, whether the income is effectively connected depends entirely on whether the activities of the permanent establishment were a material factor in producing the income. This is dependent on the facts and circumstances of the case. If the loan is one of a series of loans normally secured through the branch, it probably is effectively con-

224. There is clear authority for such a change in regulations. Int. Rev. Code of 1954, § 6001, permits the Secretary of the Treasury, whenever in his judgment it is necessary, to require any person to "keep such records, as the Secretary . . . deems sufficient to show whether or not such person is liable for tax . . . ."

225. German Hearings 32.

226. To do business in most states of the United States, foreign insurers must deposit assets sufficient to assure payment of claims with a state official. See, e.g., Cal. Ins. Code §§ 1580-99 (West 1966).

227. Contra, Tillinghast 425.

228. Contra, id.

nected. If the customer is in the country of the home office and experiences a sudden need for funds the income is probably not effectively connected, although it can be argued that the good relations with the branch were a material factor in producing the loan from the home office, rather than from a competitor, and the income should be effectively connected within the material factor test.

Earnings repatriated from the permanent establishment to the home office and there invested are not effectively connected without some greater showing.[229] This amounts to no more than a repatriation of earnings. The basic question is the functional relation of the earnings to the branch's activities, and not the source of the funds.

The area of royalties may provide some trouble, although it is more likely to do so in the German than the 1967 Convention. Assume that a foreign enterprise develops a patented product which it manufactures in its home state and sells through a permanent establishment in the United States. The company also decides to grant a United States citizen a nonexclusive license to manufacture the product in the United States. The patent rights are not held specifically for the benefit of the United States branch, because of the foreign manufacture. It has been argued that an allocation of value might be made to the United States patent rights, and that part of the rights should be considered an asset specifically for the benefit of the United States branch. There is an argument for taxation under the German Convention[230] on analogy to the provision including in business profits of the permanent establishment not only effectively connected earnings, but also income derived from the sale of goods of the same kind as those sold by the permanent establishment.[231] This argument disappears with the absence of such a provision in the 1967 Convention.

The third major division of included items under the German Convention is where the activities of the permanent establishment are a material factor in producing the income. While difficult to define precisely, the contours of this inclusion should be relatively clear. It would include, for example, a situation where the branch made the sale subject to acceptance at the home office, and the only work done by the home

229. Id.

230. Id. at 425-26.

231. Convention with the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, July 22, 1954, art. III(1), [1954] 3 U.S.T. 2768, T.I.A.S. No. 3133 (effective Dec. 20, 1954), 1 CCH Tax Treaties ¶ 3006 (1966) [hereinafter cited as German Convention], as modified, Protocol Modifying the Convention of July 22, 1954 with Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, Sept. 17, 1965, [1965] 2 U.S.T. 1875, T.I.A.S. No. 5920 (effective Dec. 27, 1965).

office is accepting the sale. It would probably not include the direct sale of goods also sold by the branch. A different result would obtain if it could be established that the promotional activities of the branch in the United States were a major factor in inducing the sale, by testimony of the customer or through demonstrating the pervasiveness of the advertising.

The 1967 Convention contains no such gloss on the phrase "effectively connected with a permanent establishment," and it might be argued from this omission that none of these tests should be used. A more likely explanation is that with the domestic terms better defined in the Protocol to the German Convention and United States law, it was thought unnecessary to incorporate an explanation in the 1967 Convention. Application of the fringes of these new concepts must await case-by-case development over the next several years. This provision will be a permanent feature in future tax conventions of the United States.

E. *Branch Profits*

United States citizens have never been happy with foreign branch profits taxes. They have thought that one of the advantages of operating through a branch is that dividends paid by the parent are not subject to taxation in the foreign country. Were this true, branch operations would have considerable foreign tax advantages over subsidiary operations. Subsidiaries pay foreign income tax on their income from abroad, and they withhold a dividend tax when the earnings are paid out to the domestic parent.

This discrimination was perceived very early. Since 1857, France has attempted to equalize the tax burdens of operating through a branch and a subsidiary.[232] The United States has similarly done so since 1921.[233] The method adopted by both countries is strikingly similar, although the measure of the tax is somewhat different. France imposes a tax on distributions to shareholders of corporations doing business in France when they receive dividends. The tax is levied on the portion of the dividend deemed derived from French earnings.[234] The portion taxed was not, however, measured by French earnings, but by a formula based either on the ratio of French assets to total assets, or French sales to total sales, expressed to the nearest tenth.[235] In 1965, as part of a

232. France § 11/3.7, at 764 n.185.

233. Rev. Act of 1921, § 217(a)(2)(B), 42 Stat. 227, 243.

234. France § 11/3.7a.

235. Id. § 11/3.7c. The use of the French assets to the total assets ratio was apparently one of the precursors of the first French-United States tax convention, namely, the 1932 Convention. The history is related in Carroll 228-29; McCaffery 398-401.

general reform in the treatment of dividends, the quota system was abolished.[236] At present, the tax is imposed on the corporation's earnings from France, after deducting the 50 percent corporation tax. The corporation makes a prepayment of 25 percent of the dividend deemed derived from French earnings to the government on behalf of the shareholder.[237]

The United States imposes a tax on a shareholder measured by his gross income from United States sources. Dividends from corporations whose income for the preceding three year period is at least 50 percent effectively connected with a trade or business carried on in the United States is from sources within the United States in the ratio that the corporation's income from United States sources during the period bears to the corporation's total income.[238] The payor of such dividends must withhold tax at the rate of 30 percent.[239]

Under the old convention, several changes were required in the French system of taxing branch profits. First, the tax was required to be computed on the basis of the percentage of profits actually derived from sources within France, rather than on the artificial basis for allocation provided by French domestic law.[240] This provision is omitted from the new convention as French law now incorporates this change.[241] Second, taxation of branch profits was limited to a situation where the United States enterprise derived profits through a permanent establishment in

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236. International Tax Law 705.

237. Norr 329. The discrimination this system of divided taxation imposes is discussed in the text accompanying notes 270-84 infra.

238. Int. Rev. Code of 1954, § 861(a)(2)(B).

239. Id. §§ 1441(a)-(b) & 1442(a). This also involves discrimination, but only in the method of payment. There is no withholding on dividends paid to persons who are not nonresident aliens or foreign corporations. Where no withholding is required, the recipient has the use of the full payment until the tax is normally due. A second discrimination is found in the fixed rate of United States tax of 30 percent on nonresident aliens and foreign corporations for dividends not effectively connected with a trade or business carried on in the United States. Int. Rev. Code of 1954, §§ 871(a)(1), 881(a). The tax rate of others will vary with the size of the income from 14 percent to 70 percent. Before the Foreign Investors Act, the 30 percent was a minimum; where the size of the income indicated a higher bracket, the higher rate was charged.

240. 1945 Convention, art. 15; Carroll, Third Tax Convention with France, 25 Taxes 208, 210 (1947) [hereinafter cited as Third Tax Convention]. This provision has been incorporated in all income tax conventions negotiated between the United States and France. See Carroll 229; McCaffery 398.

241. Of course, there is now no convention inhibition on a return to the old system of artificial allocation.

France.[242] This provision is continued in the new convention.[243] Third, the tax was assessed on three quarters of the profits derived.[244] The French have interpreted this to mean profits after the 50 percent corporate tax. This has been changed in the new convention to two-thirds of the normal base for taxation[245] and the rate of tax is reduced from the present 25 percent to 15 percent.[246] This represents a compromise between the amount of tax that would be paid by a United States citizen on portfolio income (15 percent of the full amount) and the amount that would be paid by a parent receiving dividends from a subsidiary (5 percent of the full amount). With the reduction of the base by one-third, and a maximum tax rate of 15 percent, the effective tax rate will be 10 percent.[247] Fourth, under the old convention, the tax was imposed when the profits were earned, rather than awaiting the declaration of a dividend. The new convention conforms to the French practice of imposing the tax only when the home office declares a dividend.

Under the 1945 Convention, a United States corporation was put in a less favorable tax position in two circumstances—when the ratio of French earnings to total earnings exceeded the ratio of French assets to total assets, and when the United States corporation didn't distribute at least 75 percent of its earnings in the taxable year in which they were earned. The first position no longer exists, with the abolition of the assets quota, and the second is abolished by the new convention.[248]

France has always been quite attached to its branch profits tax. Al-

242. 1945 Convention, art. 15. Although the provision reads "American corporations which maintain in France permanent establishments shall be liable [for branch profits tax] on three-fourths of the profits actually derived," it has been interpreted to preclude the assessment of any tax in the absence of a permanent establishment. The new convention will be interpreted in the same way. S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 35 (1968). This is not the only interpretation possible. See 1945 Convention Protocol, art. III; France § 11/3.7. Contra, OECD Draft Commentary 107.

243. 1967 Convention, art. 13(2)(a).

244. 1945 Convention, art. 15. This is supposedly justified as representing the amount of profits a corporation could ordinarily distribute as dividends after setting aside legal reserves, paying taxes, and amortizing its debt. Carroll 229. Obviously, French corporate taxes were much lower at that time. With the present 50 percent rate, the same rationale would demand a figure of one-third. The 1967 Convention's reduction to two-thirds is scarcely sufficient.

245. 1967 Convention, art. 13(2)(a)(i).

246. Id., art. 13(2)(a)(ii).

247. S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 35 (1968).

248. It can be argued that the corporation is only at a disadvantage if it never distributes 75 percent of its earnings. However, there is always an advantage to the taxpayer which is lost under the new convention provision. This is the reverse side of a macrocriteria Professor Joseph Sneed refers to as "Adequacy, Treasury style." Sneed, The Criteria of Federal Income Tax Policy, 17 Stan. L. Rev. 567, 572 (1965).

though the OECD Draft abolishes such taxes, France noted a reservation to that provision.[249] France has, in other tax conventions, reduced its branch profits tax. Under the Franco-German tax convention,[250] a German corporation is subject to the normal French branch profits tax. However, the amount of distributed profits subject to the tax cannot exceed the lower of one quarter of the sum normally taxable under French domestic law or the income actually realized by the French establishment of the German corporation. Although the 1967 Convention has narrowed the gap somewhat between treatment of German and United States corporations, German corporations pay an effective rate, under the new rules, of only 6¼ percent, while United States corporations pay 10 percent.

There is yet another respect in which the United States does not enjoy most favored nation treatment with respect to the branch profits tax. Under the German Convention, where a German corporation can show that more than 75 percent of its shares are held by nationals of the country of incorporation, the portion of profits taxed in France is reduced proportionately.[251] There is no such provision for the United States as it would eliminate the tax entirely in many instances.

France has been trying to eliminate the type of provision found in the Franco-German Convention as it has successfully eliminated the provision from its convention with Switzerland, with the result that it now comports with the 1967 Convention.[252]

One other type of tax on branch profits is regulated by the 1967 Convention. France has traditionally imposed registration taxes for all kinds of capital transactions.[253] Particularly vexing was the tax levied on the internal transfer of profits to capital on the books of the enter-

249. OECD Draft, art. 10(5); OECD Draft Commentary 107.

250. See Convention between the Federal Republic of Germany and the French Republic for the Avoidance of Double Taxation and the Establishment of Principles for Reciprocal Administrative and Legal Assistance with Respect to Taxes on Income and Fortune, Business Taxes and Land Taxes, July 21, 1959, art. 8(1), 9 U.N. Int'l Tax Agreements A(1) No. 68, at 4.

251. France § 11/4.6d, at 819.

252. Compare Agreement, Final Protocol and Annexes between the French Republic and the Swiss Confederation for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance with Respect to Taxes on Income and Property, Dec. 31, 1953, art. 6(1), 6 U.N. Int'l Tax Agreements 59 (1956), with Supplementary Convention between the French Republic and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital of Sept. 9, 1966, Dec. 3, 1969, art. 2, Eur. Tax Supp. Serv. § c (1970) (effective retroactively Jan. 2, 1970).

253. See generally France §§ 3/4.3-.4.

prise in order to issue a stock dividend or bonus shares.[254] The rate was 12 percent of the amount of the transfer. The new convention provides that this tax shall not be levied on profits realized by a French permanent establishment of a United States corporation.[255] However, the importance of this provision has greatly diminished in recent years. Basically, only banks, insurance companies, and specialized service companies operate through French branches. Nearly all United States manufacturers utilize French subsidiaries for their operations.

Under the 1967 Convention, for the first time, limitations are imposed on United States taxation of branch profits to benefit French residents. The new convention raises from 50 to 80 percent the gross income percentage that must be attributable to a permanent establishment in the United States before the dividend may be taxed as from United States sources.[256]

There is also some restriction in the new convention on the imposition of the personal holding company tax and the accumulated earnings tax. French corporations will be exempt from the personal holding company tax if all its stock is owned by French individuals for the entire taxable year.[257] French corporations shall be exempt from the accumulated earnings tax unless they are engaged in trade or business in the United States through a permanent establishment.[258] This is the one remnant of the force of attraction principle in the new convention. It is difficult to understand the conditions imposed for exemption from the accumulated earnings tax. If its purpose is to discourage the maintenance of funds in the corporation which would be taxed to the shareholders at a higher rate, the presence or absence of a permanent establishment in the United States would seem to be irrelevant. The significant question would be whether the shareholders were United States residents or citizens. If all of the shareholders were French residents, the purpose of the accumulated earnings tax would not be defeated by a failure to levy it because United States individual income tax would not be avoided.[259]

The United States prefers a clause outlawing all branch profits taxes, and will urge its incorporation into all future tax conventions. Where this is not possible, it will settle for a limiting clause like that appearing in the 1967 Convention.[260]

254. Id. § 3/4.4c.
255. 1967 Convention, art. 13(2)(b).
256. Id., art. 13(1)(a).
257. Id., art. 13(1)(b)(i).
258. Id., art. 13(1)(b)(ii).
259. See text accompanying notes 322-34 infra.
260. See, e.g., German Convention, art. XIV; United Kingdom Convention, art. XV.

F. *Allocation of Income Between Related Persons*

United States tax law contains provisions permitting the Commissioner of Internal Revenue to reallocate income, deductions, and credits between related parties to properly reflect the income earned by those persons.[261] Extensive regulations have been published for the guidance of taxpayers.[262]

The 1967 Convention continues the 1945 Convention's authorization for this reallocation between residents of the two countries who are related, but broadens the provision by expanding the definition of related persons to approximate section 482 of the Internal Revenue Code. Under the old convention, the provision was applicable only where one enterprise participated in the management or capital of an enterprise of the other country.[263] This covers controlled corporations and parent-subsidiary operations, but does not include brother-sister corporations or other enterprises under common control which deal with each other. The new convention provides that a person other than a corporation is related to a corporation if such person participates directly or indirectly in the management, control, or capital of the corporation.[264] A corporation is related to another corporation if there is a parent-subsidiary relation or if some person participates directly or indirectly in the management, control or capital of both corporations.[265] This leaves unresolved the question of when unincorporated organizations are related to each other. The problem should not arise, however, as partnerships and trusts are generally disregarded under the domestic law of both contracting states and for tax convention purposes. Such provisions are likely to recur in future United States tax conventions.

IV. Investment Income

The principal purpose of the provisions of the 1967 Convention relating to investment income is to encourage the free flow of capital between the two countries.[266] This is commonly done by reducing taxation on such income in the source country. The most significant change in the taxation of investment income between the old and new conventions is the abandonment of the force of attraction doctrine discussed above.[267] This makes the flow of investment easier by eliminating an impediment to investment capital by residents with a permanent estab-

261. Int. Rev. Code of 1954, § 482.
262. E.g., Treas. Reg. § 1.482-1 (1968).
263. 1945 Convention, art. 5.
264. 1967 Convention, art. 8(2)(a).
265. Id., art. 8(2)(b).
266. Chamber Talk 7.
267. See text accompanying notes 205-31 supra.

lishment in the other state. The other radical departure from standard tax conventions provides for the taxation of industrial royalties at source, with a tax rate not exceeding 5 percent.[268] At first glance, this would appear to impede investment. Whether or not actuality conforms to appearance is discussed below,[269] after specific provisions of the investment articles of the 1967 Convention are detailed.

A. *Dividends*

The 1967 Convention substantially liberalizes the taxation of dividends in the source country. Such a liberalization was greatly needed, in view of the changes in the French taxation of dividends enacted in 1965. These changes had two results. First, foreign shareholders of French corporations were to be less favorably treated than French shareholders, and second, French citizens were to be given a tax incentive to make the purchase of shares of French corporations more attractive to them than the purchase of shares of foreign corporations.[270]

To properly understand the shift brought about by the new convention, it is necessary to sketch French taxation of dividends, both before and after 1965. French corporations have been subject to tax on corporate earnings at the rate of 50 percent.[271] However, before 1965, a withholding tax of 24 percent was levied on dividends paid by French corporations.[272] The same withholding tax was imposed on dividends paid to French residents through French withholding agents by foreign corporations.[273] The tax withheld was credited on the French resident's tax return by a complex process.[274] The tax withheld from nonresidents constituted a "definitive discharge" of their tax liability.[275] This tax system resulted in general neutrality. French investors paid the same tax whether they invested in domestic or foreign corporations. Nonresident shareholders paid the same tax as resident shareholders (provided their tax bracket exceeded 24 percent).[276] It also resulted in a tax incentive to retain earnings. Out of every $200 of corporate earnings,

268. See text accompanying notes 325-37 infra.

269. See text accompanying notes 351-54 infra.

270. Norr 331.

271. France § 5/2.1. This is true both before and after 1965.

272. Id. § 9/2.12a, at 510.

273. Id. § 11/2.8f.

274. Id. §§ 9/2.12b & 11/2.8f.

275. Id. § 11/3.3, at 752-53.

276. The same discrimination against low income taxpayers is found in the United States, where the minimum rate is 30 percent. In fact, except for rate differences, and the fact that there is no withholding applicable to residents, the description of the French system prior to 1965 is applicable to the United States. Int. Rev. Code of 1954, §§ 1441-42, 871(a)(1) & 881(a); Chommie §§ 215 & 248.

one-half was taken for the corporate income tax. If the remaining $100 were invested by the corporation, the entire amount would earn further income. However, if the remaining $100 were distributed as a dividend, the shareholder would windup with only $76 to reinvest.

Under the new French dividend system, the same 50 percent corporate tax applies, but there is no withholding on payments to French residents. In computing his gross income, the shareholder includes 150 percent of the dividend he receives, and takes a credit against his tax for half the dividend he receives. The provision for "grossing up" the dividend to 150 percent is a result from a credit being given for one-half the dividend. Theoretically, by paying the corporate tax, the corporation has discharged the shareholder's tax liability through the medium of the credit. Therefore, the taxpayer has income in that amount. This is because France views its tax as a unitary tax, which is paid by the corporation for the shareholder when the corporation pays the tax on its own earnings. Thus it is called an integrated tax system. A taxpayer in a 30 percent marginal tax bracket is left considerably richer under the new system; the $200 in earnings results in a dividend of $100. His initial liability is $45 (30 percent of $150), and he has a credit of $50, $5 of which he can use against his other tax liability. In other words, net savable income rose from $70 before the reform to $105 after the reform.[277]

The system is more complex when applied to dividends paid to French

277. The foregoing description is a synopsis of Norr. His excellent work is indispensable to an understanding of the new convention, as is attested to by its frequent citation in this article. Norr suggests the following comparison between corporate and shareholder taxation before and after the 1965 reforms:

TAXATION OF CORPORATIONS AND SHAREHOLDERS (IN FRANCS)

Description	Before 1965 Reform	After 1965 Reform
Corporation Earnings Before Tax	200F	200F
Corporation Income Tax (50 percent)	100	100
Balance Available for Distribution	100	100
Gross Dividend	100	100
Withheld at Source	24	zero
Shareholder's Net Dividend Receipt	76	100
Shareholder's Tax Credit	24	50
Shareholder's Taxable Income	100	150
Shareholder's Tax	30	45
Shareholder's Credit	24	50
Additional Tax Due	6	(5)
Dividend Actually Received	76	100
Tax Benefit	(6)	5
Total Enrichment	70	105

Norr 324.

citizens by foreign corporations. Before the reform, these recipients were taxed exactly like their brethren who received dividends from French corporations. Since the reform, the withholding rate has been raised to 33⅓ percent of the dividend, and the taxpayer is required to include the dividend before calculating withholding in his gross income.[278] The withholding is then applied to his taxable income. Using the above example of a net dividend of $100, the taxpayer would receive $67, while $33 would be withheld. $100 would be included in his gross income, on which his tax, in the 30 percent bracket, would be $30. The credit of $33 would leave him $3 extra to apply to other income. Therefore, the net economic gain would be $70. This, in effect, leaves the French shareholder in a foreign corporation without the tax benefits of the reform, and therefore encourages him to purchase shares of French corporations, since their net dividends result in a greater after-tax economic gain to him.

A similar discrimination is inherent in the current treatment of dividends paid by French corporations to nonresidents. The old system of withholding on the dividend still applies here, but the rate has been raised to 25 percent. The total enrichment (before foreign taxes) would be $75 for $200 of corporate earnings, or $30 less than a French citizen would realize while the foreign tax remains unpaid.

In summary, these changes result in encouraging French residents to invest in French, rather than foreign corporations; they also result in more favorable tax treatment for French investors than is accorded foreign investors in French corporations. It would be an understatement to say that the United States was unhappy with these results. The Treasury Department contended that, even if such differential tax treatment was temporarily necessary for reasons of balance of payments, it should not have been incorporated as a structural component of the tax system, as was done by France.[279] However, negotiations leading to the 1967 Convention produced little relief.

The new convention maintains the maximum limit on taxation of dividends in the source country at 15 percent.[280] While this does not equalize the treatment accorded United States and French recipients of French dividends, it does ameliorate the discrimination, but only as to United States low income shareholders. The United States shareholder now has a total enrichment, before United States taxes, of $85—$10

278. This provision was repealed in 1967. See 1 French Income Serv. 124-26 (rev. ed. 1969). The text, however, adequately states the background of the treaty negotiations.

279. Address by Stanley S. Surrey, Assistant Secretary of the Treasury, Tax Institute of America Symposium, Dec. 2, 1965, Treas. Dep't Release No. F-291, at 2 (Dec. 2, 1965).

280. 1967 Convention, art. 9(2)(a).

more than he would have had without the new convention, on $200 of corporate earnings, but still $20 less than would accrue to a French resident.[281] Unless he is in the lowest marginal rate, the United States shareholder will have to find some additional cash to pay the excess United States income tax over the 15 percent French withholding that is creditable. More important, in terms of practical effect, this solution does nothing to eliminate the tax disadvantages facing French residents who invest in United States, rather than in French corporations. However, the tax provision does accomplish its objective which is a short-term improvement in the balance of payments situation of France.[282]

It is possible to devise a system that would eliminate the discrimination against foreign investors in French corporations and against French investors in foreign corporations. This system would give the shareholder in both corporations a credit for the allocable amount of the taxes paid to the other country by the corporation of which he was a shareholder. Of course, the shareholder would have to add the amount of this tax to his dividend in figuring his gross income. The United States currently has such a system governing the receipt of dividends by corporations.[283] Similarly, France has a similar system with respect to French shareholders of French corporations.[284] The fact that the corporation paid the tax to a foreign country is no reason to refuse to extend the system to dividends received by individual shareholders.

281. The computation worked out as follows:

Earnings of French Corporations	$200
Corporation Income Tax (50 percent)	100
Retained Earnings & distributed dividend	100
French withholding	25
Net dividend paid	75

The fact that the $15 French tax is creditable against the recipient's United States income tax both under the Internal Revenue Code and the 1967 Convention does not increase the recipient's economic gain because, in the absence of special circumstances, creditability of foreign taxes is limited to the United States tax assessed on the foreign income. Int. Rev. Code of 1954, § 904; E. Owens, The Foreign Tax Credit 291-314 (1961).

282. See Norr 321-22 for the legislative history. The United States is hardly qualified to throw the first stone. Its sin in this area is embodied in the Interest Equalization Tax, Int. Rev. Code of 1954, §§ 4911-31, which imposes a surcharge up to 15 percent of the purchase price on the purchase of stock in foreign corporations. This tax does meet Secretary Surrey's criterion by being extrinsic to the normal tax system. The tax is also temporary, id. § 4911(d), but is, of course, subject to extension, and has been extended five times, with the likelihood that it will be extended again. Interest Equalization Tax Extension Act of 1969, Pub. L. No. 91-128, 83 Stat. 201; Interest Equalization Tax Extension Act, Pub. L. No. 91-65, 83 Stat. 105; Interest Equalization Tax Extension Act, Pub. L. No. 91-50, 83 Stat. 86; Interest Equalization Tax Extension Act of 1967, Pub. L. No. 90-59, 81 Stat. 145; Interest Equalization Tax Extension Act of 1965, Pub. L. No. 89-243, 79 Stat. 954.

283. Int. Rev. Code of 1954, § 902.

284. See text accompanying note 277 supra.

The contracting states have chosen a different method to partially alleviate these difficulties. Apparently, France will make a cash payment to the portfolio of a United States shareholder of a French corporation equal to 50 percent of the dividend distributed less the applicable withholding.[285] While this equalizes the treatment of French and United States shareholders of French corporations, it does nothing for the French shareholder of a United States corporation.

The big bonus for United States enterprise in the new convention is the treatment of dividends from subsidiaries. Under the old convention, these dividends received no special treatment as the standard 15 percent rate applied.[286] Under the new convention, the tax on dividends received from a corporation in which the recipient holds at least 10 percent of the voting shares during its entire taxable year is limited to 5 percent at source.[287] This provision is more liberal than the one contained in the old convention and goes farther than the OECD Draft, which requires 25 percent ownership by the recipient corporation.[288] It does not, however, meet the stated goal of some United States tax conventions, namely, a reduction of the rate of total foreign tax to a level where it is entirely absorbed by the foreign tax credit.[289] This provision is a common feature of United States tax conventions and is greatly desired by the Treasury.

The intercorporate dividends provision has a second qualification which is designed to exclude dividends paid by holding or investment companies. The 5 percent rate only applies if, during the taxable year prior to the declaration of the dividends, the payor corporation received no more than 25 percent of its gross income from interest and dividends (other than certain kinds of active interest or dividends).[290] The exception for active interest and dividends is comprised of interest derived from the conduct of a banking, insurance, or financing business, and dividends or interest received from subsidiary corporations 50 percent or more of whose voting stock is owned by the corporation receiving the dividend.[291] The terms "dividends" and "interest" appear in the Inter-

285. Treas. Dep't Release No. K-270 (Nov. 13, 1969).

286. 1945 Convention, art. 6A. This delay in recognizing the special nature of intercorporate dividends is perhaps due to the fact that United States corporations first began using French subsidiaries in an effort to avoid the French branch profits tax. Carroll 228. The French response was to pierce the corporate entity, id., which led to the specific exclusion of subsidiary corporations from the concept of permanent establishment. Id. at 230.

287. 1967 Convention, art. 9(2)(b)(i).

288. OECD Draft, art. 10(2)(a).

289. Foreign Tax ¶ IX/5A. Under normal conditions, this would be impossible, since the French corporate tax of 50 percent exceeds that of the United States, which is 48 percent. It is accomplished during the period of the Vietnam surtax.

290. 1967 Conventions, art. 9(2)(b)(ii).

291. It appears at first reading that the words "paying corporation" should be changed to

nal Revenue Code[292] and have been defined by regulations.[293] These regulations require that the corporation be primarily engaged in "(a) [r]eceiving deposits . . . from the public; (b) [m]aking loans to the public; (c) [p]urchasing . . . [receivables]; or (d) [p]urchasing stock or debt obligations from the issuer or obligor . . . for . . . resale to the public."[294] In short, these terms encompass both commercial and investment banking. To qualify under the exception, the corporation must derive more than 50 percent of its gross income from such activities. There is also a provision that income, other than the four types noted above, may be from a banking, financing, or similar business if its production is incidental to that business, such as income derived from the investment of working capital during non-peak periods, or dividends from securities acquired on the default of a loan.[295] Income from a banking business earned by corporations owned under the Edge Act[296] is also included.[297] However, there is a proviso that no more than 20 percent of the subsidiary corporation's gross income constitutes foreign personal holding company income,[298] foreign base company sales income,[299] or foreign base company services income.[300] It is doubtful whether this detailed definition of income derived from the conduct of a banking, financing, or similar business was brought home to France during the negotiations. The general definition, including the special rules on incidental income, would appear to be unexceptional. However, France might not accept the special rules for the subsidiaries of Edge Act corporations.

The provision dealing with dividends in the new convention is significant for another reason. Never before has France accepted source rules for dividend income in a tax convention. The old convention contained source rules for several types of income. These rules were a first step toward a much-needed international agreement on allocation of income principles.[301] Under the new convention, dividends paid by a corporation of either country shall be treated as income from sources within that country unless the corporation had a permanent establishment in the other country and more than 80 percent of its gross income

read "receiving corporation," but a thorough reading of the provision indicates that it is indeed correctly drafted.

292. Int. Rev. Code of 1954, § 954(c)(3)(B).
293. Treas. Reg. § 1.954-2(d)(2) (1964).
294. Id. § 1.954-2(d)(2)(ii) (1964).
295. Id. § 1.954-2(d)(2)(iii) (1964).
296. 12 U.S.C. §§ 611-31 (1964).
297. Treas. Reg. § 1.954-2(d)(2)(iv) (1964).
298. Id. § 1.954-2(iv)(b) (1964).
299. Id. § 1.954-3 (1964).
300. Id. § 1.954-4 (1964).
301. See Owens 430, 438-41.

was taxable to such permanent establishment for a three year period ending with the close of its taxable year preceding the declaration of the dividend.[302] This source definition conforms to the limitations on taxation of branch profits discussed earlier.[303] Finally, where a prepayment (*precompte*) is levied on dividends paid by a French corporation to a United States resident, provision is made for such a resident to secure a refund on the prepayment, subject to the appropriate withholding tax of either 5 or 15 percent.[304]

B. *Interest*

The 1945 Convention limited the rate of tax on interest withheld in the source country to 15 percent.[305] The 1967 Convention reduces that rate to 10 percent, except in the case of interest on bonds issued before January 1, 1965, on which the tax is limited to 12 percent.[306] The cut-off date conforms to French domestic law[307] and, although there is no difference in principle in using the date of January 1, 1965, it does make it easier for withholding corporations by providing the same withholding rate for each issue of bonds.

The new convention contains an unexceptional definition of interest that is taken from the OECD Draft.[308] It includes income from government securities, debt claims of every kind, and "all other income assimilated to income from money lent by the taxation law of the State in which the income has its source."[309] This definition would include imputed interest derived from sources within the United States resulting from a failure to charge an adequate rate of interest on contracts calling for deferred payment.[310] Most of the imputed interest found under this provision, however, would probably be effectively connected with a permanent establishment, and thus not subject to the reduction in tax provided by the interest provision. However, there will certainly be some

302. 1967 Convention, art. 9(4).

303. See text accompanying note 245 supra.

304. See, e.g., Treas. Reg. §§ 507.22-.29 passim (1966).

305. 1945 Convention, art. 6A.

306. 1967 Convention, arts. 10(2) & (3). This provision is unusual in United States tax treaties. Usually, interest is exempt from tax at source. See, e.g., Germany Convention, art. VII(1). A small tax conforms to the OECD Draft, art. 11(1)-(2). The exemption of interest dates back to an early League of Nations report suggesting that where the source country taxes interest, the lender will force the borrower to pay the tax. L.N. Doc. No. F (73/F/19) [1923] at 8-9; International Tax Law 697.

307. France § 9/1.2b.

308. 1967 Convention, art. 10(5); OECD Draft, art. 11(3).

309. 1967 Convention, art. 10(5).

310. Int. Rev. Code of 1954, § 483(a).

interest that is not effectively connected with a permanent establishment under this provision, such as the casual sale of real estate.

The new convention also contains a source rule for interest.[311] Interest paid by one of the contracting states, a political subdivision, or a resident thereof, is considered income from sources within that country. This is also the rule under the domestic law of the United States.[312] When the person paying the interest has a permanent establishment in one country, in connection with which the indebtedness on which the interest is paid was originally incurred, and the interest is borne by that permanent establishment, that interest is deemed to be sourced in the country of the permanent establishment.[313] This provision has no analogue in United States domestic law. The other minor exceptions to the principle that interest is sourced in the country of the payor found in the Internal Revenue Code[314] are not carried over into the new convention.

There is a provision in the new convention relating to both interest and royalties which provides that where, due to the relationship between the payor and the recipient, the amount of interest or royalties exceeds an arm's length payment, the reduced rate for interest and royalties shall apply only to the arm's length amount.[315] Presumably, the same result could have been reached under article 8 of the new convention, relating to reallocations between related persons.[316] Its inclusion in these specific provisions reflects the official belief that misallocations of interest and royalties occur quite often.[317]

Finally, interest received by one country, or by an instrumentality thereof not subject to income tax in that country, is exempt at the source.[318] All of the above provisions relating to interest can be expected to be carried over future tax conventions negotiated by the United States.

C. *Royalties*

The new convention defines the term royalties. The definition is substantially expanded to conform largely to the OECD Draft[319] by including consideration for "the right to use, patents, designs or models,

311. 1967 Convention, art. 10(6).
312. Int. Rev. Code of 1954, § 861(a)(1).
313. 1967 Convention, art. 10(6).
314. Int. Rev. Code of 1954, § 861(a)(1).
315. 1967 Convention, arts. 10(7) & 11(7).
316. Id., art. 8(1).
317. See text accompanying notes 327-29 infra.
318. 1967 Convention, art. 10(8).
319. OECD Draft, art. 12(2).

plans, secret processes or for formulae, trademarks, or other like property or rights . . . ."[320] It also includes gains from the sale or exchange of any such right if the payment is contingent on the future productivity of the property.[321]

The 1967 Convention also makes substantial changes in the treatment of royalties. Under the old convention, certain enumerated royalties were exempt from tax in the source country, provided that the recipient maintained no permanent establishment there.[322] Under the new convention, royalties, like Gaul, are divided into three parts. Movie royalties are considered to be business profits.[323] Copyright royalties for literary, artistic, or scientific works, including gains realized from the sale or exchange of property giving rise to those royalties, are still exempt from tax in the source country.[324] Industrial royalties, however, are subject to a 5 percent tax in the source country.[325] The change in treatment for industrial royalties resulted from two feelings on the part of France. The first was that the balance of payments on industrial royalties was so overwhelmingly against them that the revenue loss was quite serious.[326] The second was that excessive amounts had been paid by French concerns to United States concerns as royalties and, these amounts were in fact disguised dividends. France hoped that by taxing these royalties, a more thorough investigation would be made. Due to the deductibility of royalties, however, it was still advantageous to classify any distribution as a royalty, rather than as a dividend, in the hope that the fiscal authorities would not discover the change.

The new regime for royalties is quite proper. Although it can be argued that interest and royalties should be treated identically, since they have the same properties as investment vehicles, a significant difference does exist. Interest infidelities are readily corrected through the use of reallocation devices.[327] The fair market rate of interest can be determined with at least reasonable accuracy. A fair royalty, however, is much more difficult to assess in the light of various products and other differences. Particularly in the field of know-how royalties, the fair

320. 1967 Convention, art. 11(4)(a).

321. Id., art. 11(4)(b).

322. 1945 Convention, art. 7; Carroll 231, 233.

323. 1967 Convention, art. 6(5); see text accompanying notes 109-21 supra.

324. 1967 Convention, art. 11(3).

325. Id., art. 11(2).

326. The feeling of France that its balance of royalty payments with the United States is very unfavorable is supported by the limited and inadequate statistics available to the public. See Airgram A-416 from the American Embassy in Paris, France, to the Department of State, Sept. 8, 1967, provided through the courtesy of Mr. Frederick Strauss, Director, European Division, Bureau of International Commerce, U.S. Dep't of Commerce.

327. See Int. Rev. Code of 1954, § 482.

value of the services becomes quite difficult to ascertain. This provides a fertile field in which to transmute dividends into royalties.

Although this would at first seem to be a derogation from the OECD Draft, which provides a complete exemption for royalties in the source country,[328] there are special derogations to that Draft for Greece, Luxembourg, Portugal, and Spain, who were unwilling to relinquish source taxation on royalties but would be willing to limit that taxation to 5 percent, and Austria and Turkey, who wanted to limit it to 10 and 20 percent, respectively. Each of these countries are less developed countries in which the flow of royalites is heavily outward. Thus, two principles arise from the OECD Draft. First, where the flow of royalties is about even, no tax will be levied at the source, and second, where there is a substantial disparity in the flow of royalties, a 5 percent tax may be levied at source. Thus, the spirit of the OECD Draft has been preserved by this provision.

Royalties for the right to use property in one country constitute income sourced in that country.[329] This conforms to United States domestic tax law,[330] but France considers royalties sourced where the patent or process was developed.[331] This provision generally conforms to the domestic law of the United States, without the extraordinary distinctions drawn between royalties and capital gains.[332] However, one significant difference from the OECD Draft lies in the exclusion of payments for the right to use industrial, commercial, or scientific equipment. These payments constitute royalties under the OECD Draft,[333] but are considered business profits by the new convention on the rationale that they are derived from the rental of tangible property.[334]

D. *Capital Gains*

The capital gains provision of the 1945 Convention has been substantially revised by the 1967 Convention. Under the 1945 Convention, capital gains derived in one of the states from the sale or exchange of stocks, securities or commodities by a resident of the other state were exempt from taxation if the resident had no permanent establishment in the source state.[335] There was no provision in the old convention related to the sale of other types of capital assets. The provision in the

328. OECD Draft, art. 12(1).
329. 1967 Convention, art. 11(6).
330. Int. Rev. Code of 1954, § 861(a)(4).
331. France § 9/5.2b.
332. Rev. Rul. 353, 1958-2 Cum. Bull. 408; Chommie § 117.
333. OECD Draft, art. 12(2).
334. 1967 Convention, art. 6(5); see text accompanying notes 122-30 supra.
335. 1945 Convention, art. 11.

new convention covers all types of capital assets[336] except sales of royalty-producing property where the purchase price is dependent upon continued productivity of the property,[337] and gain from the sale of real estate cooperatives whose property is principally located in the other state.[338] The former are governed under the royalties provision and subject to the limited 5 percent tax at source;[339] the latter may be fully taxed in the source country under the provision pertaining to income from real property.[340] The new convention's treatment of shares of real property corporations as real property conforms to the domestic practice of France.[341] Under United States domestic law, they are taxable in the same fashion as other corporations.

Under the new convention there are three exceptions to the general rule that capital gains are not subject to tax at source. First, like other types of investment income, capital gains effectively connected with a permanent establishment in the source country are subject to tax under the business profits provision.[342] Second, an individual deriving capital gains from the other country does not obtain the benefits of the capital gains provision if he maintains a fixed base in the source country and the property giving rise to the gain is effectively connected to the fixed base.[343] This clause refers to persons who perform personal services in the other country through a fixed base. It is analogous to the concept of gains which are effectively connected with a permanent establishment. Gains which are effectively connected to a fixed base would tend to be gains that should be regarded as profits from personal services, just as the performance of the services themselves constitute the purpose of the fixed base. The source of this provision is the OECD Draft.[344] The third exception is the individual who is present in the source country for more than 183 days during the taxable year. This provision, which conforms to United States domestic law,[345] is not found in the OECD Draft or in French domestic law. It is difficult to justify this 183 day rule except on the ground that the capital gain is earned substantially by the acumen of the individual owning the property. Since this individual is present in the source country for more than one-half the year, the

336. 1967 Convention, art. 12(1).
337. Id., art. 11(4)(b).
338. Id., art. 12(2)(a).
339. Id., art. 11(2).
340. Id., art. 5.
341. See France § 10/6.5.
342. 1967 Convention, art. 12(2)(b).
343. Id., art. 12(2)(c)(i).
344. OECD Draft, art. 13(2); S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 34 (1968).
345. Int. Rev. Code of 1954, § 871(a)(2).

source country should be able to tax the gain on an analogy to personal services income. The new capital gains provisions are a substantial improvement and tend to conform the 1967 Convention to the other income tax conventions of the United States.

E. *Real Property*

Income from real property and royalties on natural resources are taxable in the source country, as well as income from the sale or exchange of those assets.[346] A person may elect to be taxed in the source country on such real property income as if he were engaged in business there.[347] This means that he will be allowed the deductions appropriate to earning the income. These provisions are substantially the same as in the 1945 Convention.[348] However, the changes make it clear that the election to be taxed as though business were done in the source country is only with respect to the real property income, and not with respect to all income. Furthermore, the net election is available in both countries, whereas under the old convention, it was only required in the United States. This provision is in conformity with present United States domestic law,[349] although the convention provision allowing that election was the predecessor of this provision. France has always taxed real property of nonresidents on a net basis.[350] Such a provision is found in most United States income tax conventions.

F. *Impact on Flow of Investment*

The provisions in income tax conventions relating to investment income have several purposes. First, they are designed to reduce tax impediments to the free flow of capital between the two countries.[351] Second, they should eliminate double taxation and prevent fiscal evasion with respect to the investment income. Third, they should expedite relations between the residents of one country and the taxing authorities of the other. Fourth, they should provide a reasonable allocation of tax revenue between the two governments.

The new convention is relatively successful in eliminating tax impediments to the free flow of capital between the two countries. The limited tax that is authorized for interest and royalties will all be creditable in the other country, even at the lowest tax bracket. The capital

346. 1967 Convention, arts. 5(1)-(2) & 12(2)(a).

347. Id., art. 5(3).

348. 1945 Convention, art. 7, as supplemented, 1945 Convention Supplementary Protocol, art. 7(b).

349. Int. Rev. Code of 1954, § 871(d).

350. See France §§ 9/4.2 & 11/3.9.

351. Chamber Talk 7.

gains provision will largely eliminate tax on capital gains in the source country, thereby removing tax considerations from investment demands of residents of the two countries. However, there is less success in the area of dividends. Taxation on the receipt of dividends by United States individuals (and corporations holding less than 10 percent of the payor's stock) is relatively neutral. The entire tax imposed on the dividend is creditable against the United States tax. For corporations holding more than 10 percent of the payor's stock, the combination of the corporate income tax and the withholding exceeds the United States tax on the income, so there is some lack of incentive to invest in French concerns. However, there would be considerably less incentive to invest in French concerns in the absence of the new convention. There is also a substantial tax impediment to French investment in United States corporations, but again, less than there would be without the new convention. This lack of incentive results almost entirely from the French system of taxation. The new convention makes some adjustment, but a credit for taxes paid by the United States corporation could completely remove impediments to French investment.[352] Such a credit would partially defeat the purpose of the recent reforms in French domestic law.

The new convention is successful in preventing double taxation and fiscal evasion on most investment income. Taxation at source is limited to a relatively low rate that can, in most cases, be credited against the normal tax in the country of residence. The new convention provides for a mandatory credit for this tax. Prevention of fiscal evasion is relatively easy except for capital gains and real property income. For dividends, interest, and royalties from the United States, the recipient receives reduced withholding, either on the basis of his address, or by filing a simple form in the source country.[353] In France, the recipient claims a refund. Lists of persons who secure reduced withholding or claim refunds are to be regularly exchanged by the two countries. However, there is normally no withholding on capital gains or real property income, and no possible reduction of the latter. For this reason, it is difficult for the source country to notify the country of residence of the income. While not serious in the case of real property income, since it is taxed at least at the source, it might be a serious area of evasion for capital gains.

The administrative procedure worked out by the United States for securing the reduced rate of tax is easy to follow and does not embroil the French resident in filing annual returns or seeking refunds. A form

352. See, e.g., Int. Rev. Code of 1954, § 902.

353. Treas. Reg. § 514.2(c)(1) (1957) provides for reduced dividend withholding by address. Treas. Reg. § 514.4(b)-5(b) (1957) provides for reduction in or exemption from withholding of interest and royalties by filing Form 1001-F or 1001A-F, whichever is appropriate.

is to be filed at the beginning of the year entitling the withholding agent to reduce the rate of withholding set in the convention.[354] If France sets up a similar system (as the inclusion of the *precompte* in the list of taxes covered indicates it will), simplicity for the taxpayer will be achieved.

The new convention does nothing in the investment income area to provide a reasonable allocation of the tax revenue between the two governments. The provisions are designed to assure that the entire tax will be collected by the country of residence except on dividends and royalties, where a small tax is collected at the source. Since most industrialized countries have a similar corporate tax rate of 50 percent, it should be easy for the two countries to agree on taxation at source at a 25 percent rate on investment income, thereby splitting the revenue. However, it should immediately be apparent that the goal of allocating revenue is inconsistent with the other goals, such as reducing impediments to the flow of investment, eliminating double taxation, and reducing administrative annoyance for the taxpayer. For this reason, taxes have been kept minimal in the source country. It should be recognized that this represents a conscious policy choice, rather than the more specious basis from which it has been viewed.

V. Personal Service Income

The provisions relating to personal service income are not changed in significant respects in the 1967 Convention. For the most part, the changes consist of modifications, modernizations, and clarifications of language contained in the 1945 Convention.

Although there are no basic changes relating to personal service income in the 1967 Convention, the failure to include United States state and local taxes within the convention for purposes of the personal service provisions is difficult to understand except in terms of the theory of federalism. Under the provisions of the new convention, certain individuals temporarily present in the United States are spared federal income tax because of the briefness of their contact and the convenience this provides them. When these individuals are unexpectedly subject to state or local levies, they are occasionally financially embarrassed and usually annoyed.[355] The convenience of exemption therefore partially disappears. Despite anguished screams of states rights, a provision which would include state and local taxes in a convention would be desirable. The same result can be attained by persuading the states involved to exempt from their state income tax those persons exempt from federal

354. Treas. Reg. § 514.4(b)(5) (1957).

355. Kragen 312.

tax by convention.[356] As related to the provision dealing with governmental functions in the 1967 Convention, only a few jurisdictions would be involved, such as California, the District of Columbia, Illinois, New York, and Pennsylvania. However, the other Convention provisions would require concurrence of all states to be effective.

A. *Governmental Functions*

Under the 1945 Convention, compensation (including pensions) paid by a country or a political subdivision thereof to individuals residing in the other country was exempt from tax in the residence state. Nationals of the recipient state were not included in the exemption.[357] The provision in the 1967 Convention is less liberal than the former convention or the OECD Draft.[358] Remuneration (including pensions) paid by a country or a political subdivision thereof is taxable only in the source state, but the 1967 Convention provision is limited to (1) nationals of the source state and (2) payment for services rendered in discharge of governmental functions.[359] Thus, nationals of third countries, formerly protected, are denied the benefits of the 1967 Convention. In addition, there is no attempt to solve the many problems which may arise in trying to determine what might be a legitimate governmental function.[360] This varies from state to state, and, while France and the United States do not differ strikingly, perhaps the principal difference relates to the instru-

356. Under D.C. Code Ann. § 47-1557a(b)(7) (1967), gross income does not include income to the extent required to be excluded by United States tax convention obligations. This probably does not include amounts excluded from gross income for federal income tax purposes, as its apparent purpose is to exempt no more than the tax conventions require. Some state statutes incorporate the Int. Rev. Code of 1954 within their definition of gross income, thereby including section 894 of the Code, which excludes from gross income amounts excluded by tax convention. E.g., Hawaii Rev. Laws § 121-1 (Supp. 1965).

357. 1945 Convention, art. 8, as supplemented, 1945 Convention Supplementary Protocol, art. 7(c).

358. See OECD Draft, art. 19.

359. The United States has taken the position that Article 14(A) of the 1945 Convention (the savings clause) limited the application of Article 8 (governmental functions) to citizens of France. Treas. Reg. § 514.110(a) (1946); Foreign Tax ¶ IX/10H(3). The language of Article 14(A), that the United States may tax its residents as though the Convention had not come into effect, does not justify this interpretation as it would justify the complete gutting of the governmental services provision. On the other hand, it can be argued that since a literal reading of Article 14(A) would destroy the governmental services exemption, Article 8 must be read literally and, therefore, should be outside the limits of Article 14(A). The savings clause is specifically made inapplicable to the government services provision in the new convention. 1967 Convention, art. 22(4)(a)(iii).

360. French Republic v. Board of Supervisors, 200 Ky. 18, 252 S.W. 124 (1923). See generally L. Orfield & E. Re, Cases & Materials On International Law ch. 11 (1955).

ments of transportation and communications, which are governmentally operated in France. However, this presents no problem, since French communications workers are unlikely to be in the United States, and special convention provisions govern ship and aircraft crews.[361] These provisions do not apply to ground personnel such as mechanics and ticket sellers, etc. Government payments for non-governmental services are taxable under the other personal service provisions.[362]

In the case of individuals with dual nationality, the 1967 Convention provides that each country may tax its own nationals, but must consider income paid by a country or its political subdivisions to be income sourced in the paying country.[363] The paying country would thereby have the prior right to tax that income, and the other country would credit the tax.

B. *Dependent Personal Services*

The treatment of income from employment is similar in both the 1945 and 1967 Conventions. A resident of one country is exempt from tax on compensation for personal services performed in the other country if the employee was present in the latter country for less than one-half of his fiscal year.[364] This is the familiar 183 day rule common to all income tax conventions. The 1945 Convention contained an additional proviso that the services must have been performed for an enterprise of the individual's residence state, or for a permanent establishment of an enterprise of the state of performance if the permanent establishment was located in the residence state.[365] An employee of a permanent establishment of a third country enterprise might have been subjected to double taxation under this proviso because his residence and his employer's residence did not coincide. The comparable provision of the 1967 Convention provides that to be eligible for exclusion, the compensation may not be paid by a resident of the source state or the expense borne by a permanent establishment located in the state of performance. The 1967 Convention is more stringent as it provides that remuneration may not be paid by a permanent establishment in the source country.[366] While narrower in this respect, it expands coverage to possible third parties and shifts the emphasis from whom the services are performed for to the business-accounting criterion of who bears the expense of

361. 1967 Convention, art. 15(3).
362. Id., art. 16(2).
363. Id., art. 16(3).
364. Id., art. 15(2).
365. 1945 Convention, art. 9, as supplemented, 1945 Convention Supplementary Protocol, art. 9.
366. S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 36 (1968).

performance. The term "borne" should be interpreted to mean deducted from income. Its purpose is to eliminate the exemption where the salary paid would be a deductible expense in the same country. Either the payment must be excluded from bookkeeping in the country of performance, or it must be included in its entirety. The symmetry of the clause is laudable, but one wonders at its practicality. The payor's bookkeeping is likely to be out of the control of the employee. Also, if the purpose of the provision is to reduce tax harassment, whether or not the salary is borne in the performance country is irrelevant. This provision conforms to the OECD Draft,[367] which regrettably provides no explanation as to its meaning. One justification advanced for this provision is that there is no fixed dollar maximum on the amount of income that can be excluded in this fashion, as there is in other United States tax conventions.[368] The provision is thus designed to prevent avoidance of tax by high income taxpayers who control permanent establishments in the performance country, and could otherwise arrange their affairs in a most advantageous manner. This provision only prevents avoidance in this one area. A fixed dollar limitation would be a better check on possible wide abuse of this provision. Its advantage would be that an individual with a sizeable income can afford to hire professional help in the performance country to adjust his taxes, whereas a low income individual whose salary is borne by a permanent establishment in the performance country is subject to the necessity of dealing with two governments.

Under the 1967 Convention, personal services income of ship and aircraft crews is taxable only in the residence state of the owner, if the craft is registered therein.[369] This provision has the same basic justification of preventing allocation difficulties and securing certainty for the parties as the provision dealing with shipping profits.[370] It is more necessary in this case, since the taxpayers are unlikely to possess the means of litigating tax controversies and are too mobile to successfully do so.[371]

C. *Teachers*

The 1967 Convention contains a specific provision relating to teachers.[372] Although similar provisions appear in other tax conventions, the inclusion of the special provision in the new convention followed a series of acrimonious disputes between teachers of one country and the tax authorities of the other. The disputes arose primarily from the

367. OECD Draft, art. 15(1)-(2).
368. OECD Draft Commentary 131; see text accompanying note 393 infra.
369. 1967 Convention, art. 15(3).
370. See text accompanying notes 99-100 supra.
371. OECD Draft, art. 15(3).
372. 1967 Convention, art. 17.

liberal profession article of the 1945 Convention,[373] since that convention contained no specific provision dealing with teachers. France defined the term "exercise of a liberal profession" to include only independent activities.[374] On the other hand, the United States took the position that a liberal profession involved activities which required qualitative judgments.[375] However, since "liberal profession" is a term of art in French domestic tax law and unknown to United States domestic law, the French definition should have been given the greatest weight. Finally, and reluctantly, the Internal Revenue Service accepted the French usage. Since teachers are always employed, the Internal Revenue Service ruled that French teachers in the United States were not exempt from tax under the 1945 Convention provision.[376] That ruling placed teaching under the less favorable rules for dependent personal services.[377] The change of position of the United States was made in the name of reciprocity to induce France to change its ruling. When the 1967 Convention was being negotiated, the position of France changed, and the United States, accordingly, re-established its favorable view for teachers.[378]

The 1967 Convention permits teachers to visit an accredited institution, for a maximum of two years, for teaching, research, or both, free of tax in the source state.[379] This eminently sensible solution averts two undesirable effects. First, the integrity of the French definition of "liberal profession" in its domestic law is not threatened. Second, it avoids the anomalous result reached under other tax conventions that foreign professors in the United States teaching one course and conducting research are exempt from United States tax, while professors engaged solely in research are not.[380] The new provision on teachers, which does not apply to income from research if such research is undertaken

373. 1945 Convention, art. 10.

374. France § 8/1.1c, at 447; see Rev. Rul. 92, 1964-1 Cum. Bull., pt. 1, at 599, 600.

375. Rev. Rul. 313, 1960-2 Cum. Bull. 627; Rev. Rul. 508, 1955-2 Cum. Bull. 775.

376. Rev. Rul. 92, 1964-1 Cum. Bull., pt. 1, at 599, 600.

377. 1945 Convention, art. 9.

378. Rev. Rul. 353, 1968-2 Cum. Bull. 705; Rev. Rul. 357, 1966-2 Cum. Bull. 564; T.I.R. No. 833, July 12, 1966.

379. 1967 Convention, art. 17(1); see Rev. Rul. 357, 1966-2 Cum. Bull. 564. This has been amplified by Rev. Rul. 353, 1968-2 Cum. Bull. 705, holding that a French professor engaged in research activities in the United States is exempt from income tax under the 1945 Convention. In essence, the ruling holds that research is a sufficiently common adjunct to typical academic duties to preclude limiting the term "professor" to those individuals having only teaching responsibilities.

380. See, e.g., United Kingdom Convention, art. XVIII; Rev. Rul. 23, 1960-2 Cum. Bull. 754; Rev. Rul. 508, 1955-2 Cum. Bull. 775.

primarily for the private benefit of a specific person, has been quite common in past United States tax conventions.[381]

The two year provision creates the possibility of double exemption for United States teachers who are temporarily in France. United States domestic law allows an individual who is abroad for at least five hundred and ten days, during an eighteen month period, to exclude from his gross income up to $20,000 of earned income from sources abroad.[382] The 1967 Convention allows a United States teacher teaching in France for up to two years an exemption from French income tax. Combining the two provisions, such a United States teacher would pay no income tax on his teaching income. One solution would be to limit the convention's exemption to individuals who are out of the country for no more than five hundred and nine days out of an eighteen month period. The other solution would be to require that the income earned outside the country be includable in income for United States tax purposes.[383] No such problem exists on the French side, however.[384]

The two year provision raises another problem. If a teacher remains abroad for more than two years, does he lose the exemption for the first two years that he was abroad? It can be argued that since the purpose of the exemption is to eliminate the necessity of dealing with foreign tax administrators when you are in the country for only a limited period of time, a longer stay should subject you to full source country liability. However, the better result would be to retain the benefits of the convention already used. Taxability at that late date would impose a burden on the teacher to find three years' taxes in one year, and would involve him in the refund procedures of his home country in order to secure

381. Cf. Norway Convention, art. XII. There is no comparable provision in the OECD Draft.

382. Int. Rev. Code of 1954, § 911(a)(2), (c)(1).

383. Such a provision is found in the tax convention that the United States entered into with the Union of South Africa, Protocol Supplementing in Certain Respects the Convention for the Avoidance of Double Taxation and for Establishing Rules of Reciprocal Administrative Assistance with Respect to Taxes on Income Which Was Signed at Pretoria on December 13, 1946, July 14, 1950, art. II(1), [1952] 3 U.S.T. 3841, T.I.A.S. No. 2510 (effective July 15, 1952), 2 CCH Tax Treaties ¶ 7952 (1968) [hereinafter cited as South Africa convention Protocol], supplementing Convention with the Union of South Africa for the Avoidance of Double Taxation and for Establishing Rules of Reciprocal Administrative Assistance with Respect to Taxes on Income, December 13, 1946, [1952] 3 U.S.T. 3821, T.I.A.S. No. 2510 (effective July 15, 1952), 2 CCH Tax Treaties ¶ 7903 (1968) [hereinafter cited as South Africa Convention].

Rev. Rul. 122, 1969-1 Cum. Bull. 193, holds that excludable income is outside the exemption provided for in this convention.

384. France § 11/2.11.

proper credit for the taxes paid. Nor should a rule that depends on the teacher's intention at the time of beginning the visit be adopted. Proof of one's intent three years previous would be difficult at best, and would result in conflicting results in similar cases. Furthermore, an individual can benefit by more than one of the personal services articles in successive years up to a limit of five.[385] The implication of this is that the length of the stay in the foreign country is not dispositive. Finally, the language of the provision itself leads to the same conclusion:

> An individual . . . who . . . visits the latter Contracting State for the primary purpose of teaching or engaging in research . . . shall be exempt from tax by the latter Contracting State on his income from personal services for teaching or research . . . for a period not exceeding 2 years . . . .[386]

It is clear that the exemption may not exceed two years; however, nothing is said of the duration of the employment in the 1967 Convention.[387]

D. *Students and Trainees*

Students abroad, under the 1945 Convention, were exempt in the country of study from tax only on remittances from their home countries.[388] The 1967 Convention has broadened this coverage by adding professional trainees and persons studying or doing research under a grant from a charitable organization.[389] Students on grants also represent an additional extention since the grant may be paid by sources in either country while taxable only in the students' residence country.[390] Finally, income from personal services performed in the country of study (to a maximum of $2,000 per year) may be excluded from tax in that country.[391] Since students often are present in one country for a period of years, this last provision is a reasonable recognition of the importance of permitting them to maintain themselves by supplementing whatever funds they receive from abroad. In addition, the inclusion of this broad provision in the 1967 Convention appears to be a recognition of the extent of private and organized student exchange between the contracting states. The exclusion simplifies the income reporting burden for a class of persons commonly believed to be unfamiliar and unconcerned with practical and administrative matters.

The exemption is new to United States-France tax conventions and

385. 1967 Convention, arts. 18(1)(c) & 21(2).
386. Id., art. 17(1).
387. Rev. Rul. 236, 1969-1 Cum. Bull. 193.
388. 1945 Convention, art. 12. The OECD Draft is in accord. OECD Draft, art. 20.
389. 1967 Convention, art. 18(1)(a), (b)(i).
390. Id., art. 18(1)(b)(ii).
391. Id., art. 18(1)(b)(iii).

has no parallel in the OECD Draft, but is found in several other United States tax conventions. Since the benefits are relatively generous, they are extended only for the time that is reasonably or customarily required to complete the studies. There is an outside limit of five years placed on the benefit of the student and teacher provisions combined.[392]

The 1967 Convention also offers an exemption for personal services income of employees of a resident of one of the contracting states who is temporarily present in the other to study, or to acquire technical, professional or business experience. This exemption is limited to one year and $5,000.[393] This appears to be a specialized loosening of the 183 day rule in the dependent personal services article which, for indexing purposes, fits better in article 18(2).

E. *Pensions and Annuities*

The state of the recipients residence has the exclusive right to tax alimony payments, annuities, and private pensions under the 1967 Convention.[394] Except for the addition of alimony, this provision constitutes no change from the 1945 Convention.[395] The old convention used the term "life annuity."[396] However, there was no requirement that annuities be measured by a lifetime. They could be measured by a term of years.[397] Thus, the new convention rectifies a surface ambiguity of the former convention.[398]

The new convention defines pensions as periodic payments made after retirement in consideration of, or for injuries sustained in, past employment.[399] The definition seems to be unexceptional.[400]

Social security payments are the subject of a special provision in the 1967 Convention which permits the taxation of such payments only by the payor country.[401] This provision is a limited reversal of a recent United States ruling, which permitted taxation of foreign pensions in

392. Id., art. 18(1)(c).

393. Id., art. 18(2).

394. Id., art. 19. This would seem to solve the problem of the United States citizen who marries a foreigner and, after divorce, returns to the United States and receives alimony. See Kragen 311 n.19.

395. 1945 Convention, art. 8.

396. Id.

397. 1945 Convention Protocol, art. IV.

398. See 1967 Convention, art. 19(3).

399. Id., art. 19(4).

400. The OECD draft does not define the term "pensions," OECD Draft, art. 18, but the Commentary indicates that widows' and orphans' pensions and annuities for past employment are covered. OECD Draft Commentary 135. However, there is no mention of disability payments.

401. 1967 Convention, art. 20.

spite of their similarity to United States social security payments.[402] The United States and France differ radically in the timing of taxation of social security payments. The United States includes the taxpayer's contribution in his gross income when earned, but does not tax the benefits upon distribution.[403] France, on the other hand, excludes the taxpayer's contribution when earned and taxes the benefits in the year paid.[404] By French administrative action, a recipient whose total retirement income is small may be exempted from tax on his pension.[405] Thus, without the provision in the new convention, a recipient of United States social security who is residing in France would be subject to double taxation and, under present United States domestic law, a recipient of French social security could be denied an administratively granted exemption. Granting exclusive taxing power over social security payments to the paying country provides a salutary solution to possible conflicts which would involve a group of persons who would be least capable of financing private solutions. Although such a provision is not found in the OECD Draft, its incorporation would be advantageous.

F. *Independent Personal Services*

The treatment of income from independent personal services partakes of both dependent personal services and business profits. Income is exempt from tax in the source country unless the individual was either present, or maintained a fixed base, in the source country for more than 183 days during the taxable year.[406] Taxation on the basis of presence aligns the provision with dependent personal services. The concept of fixed base is quite similar to the permanent establishment concept familiar to business profits taxation. Presumably, it requires a fixed place of business belonging to the individual or usable primarily by him. How fixed the base must be, or how exclusive the use is not clear.

The new convention defines independent personal services as all activities (other than industrial, commercial, or agricultural) carried on independently by a profit-seeking, loss-bearing individual.[407] This defini-

402. See Rev. Rul. 34, 1966-1 Cum. Bull. 22, which revoked Rev. Rul. 135, 1956-1 Cum. Bull. 56. However, foreign social security payments are treated like other annuities under Int. Rev. Code of 1954, § 72.

403. I.T. 3447, 1941-1 Cum. Bull. 191-92; 1 J. Mertens, Federal Income Taxation § 7.45 (1969).

404. See France § 8/1.9b.

405. Id. §§ 8/1.9b n.40 & 12/1.6c.

406. 1967 Convention, art. 14(1), (2). This provision was adapted from Article 14(1) of the OECD Draft, with the 183 day rule for dependent personal services that is used in the Draft read into the new convention in order to provide more certainty for the slippery concept of fixed base.

407. 1967 Convention, art. 14(3).

tion is better than the OECD Draft which refers to professional services and, rather than defining the term, illustrates it by referring specifically to independent scientific, literary, artistic, educational or teaching activities. The OECD Draft illustration also includes physicians, lawyers, engineers, architects, dentists, and accountants who are engaged in independent activities.[408] Thus, a more precise definition might have been inserted to avoid application of the rule of *ejusdem generis* to eliminate a number of other independent activities of the artisan class that the countries wished to include. More important, the application of this rule might have eliminated entertainers, an important group that is considered in United States tax negotiations. The new convention is a remarkable coup for the United States because no dollar limit is imposed on the exemption of income from personal services in the source country. Many countries have used a limit or a special provision to prevent entertainers, who earn a great deal of money in a limited amount of time, from exporting large amounts of it without being subject to tax.[409]

G. *Other Personal Services Income*

The 1967 Convention does not refer to several types of income commonly covered by other tax conventions. One such type is directors' fees and similar payments. Under the OECD Draft,[410] these payments could be taxed in the state in which the corporation is a resident. This provision is justified on the ground that it is sometimes difficult to ascertain where the directors' services are performed.[411] The problem is usually not treated in United States tax conventions because directors' fees in United States corporations differ substantially from those in European corporations. In the United States, a director of a corporation may receive little more than expenses for his participation in directors' meetings, or he may receive a sizeable sum.[412] In Europe, on the other hand, directors commonly receive three types of remuneration. They sometimes receive compensation for personal services, allowances for attendance at directors' meetings, and directors' fees that constitute profit sharing payments.[413] In the United States, those payments would all be taxed as personal services income. The omission of these matters from the new

408. OECD Draft, art. 14.

409. See, e.g., Agreement between Israel and France for the Avoidance of Double Taxation and the Establishment of Rules for Reciprocal Administrative Assistance with respect to Taxes on Income, Aug. 20, 1963, art. 17, 9 U.N. Int'l Tax Agreements A. (1) No. 116, at 5.

410. OECD Draft, art. 16. The United States entered no reservation to this provision, but Canada did. OECD Draft Commentary 133.

411. OECD Draft Commentary 133.

412. See H. Ballantine, Corporations § 73, at 187 & § 74, at 189 (rev. ed. 1946).

413. France § 8/3.2, at 479 & § 9/25, at 506-07.

convention means that the United States will subject directors' fees to the personal services provision. However, France will probably continue to tax directors' fees under its domestic rules.

A second class of personal services income not given special treatment is that received by artists and athletes. The OECD Draft[414] provides that regardless of the provisions of the personal services articles, the income of public entertainers, including athletes, may be taxed in the country in which the activity is carried on. The OECD Draft takes an uncertain position, realizing that many countries will wish to treat athletes and artists under the normal provisions, and suggests that full taxability only be decreed when the public entertainer is acting independently.[415] This suggestion would only serve as a trap for the unwary since a public entertainer can incorporate himself, thus becoming subject to the dependent personal services provision while the corporation remains subject to the business profits provision.[416] The new convention leaves this possibility open, and taxes the remuneration of public entertainers as dependent or independent personal services as the case may be. In view of the past adverse reaction of the United States Senate to any contrary suggestion, this is probably necessary.[417]

In addition to normal compensation, the personal services provisions apply specifically to reimbursed traveling expenses,[418] but such expenses are not considered in computing the maximum exemption for students or trainees.[419]

The close interrelationship of the personal services provisions raises the possibility that an individual may qualify under more than one of them. The new convention provides that only one of these provisions (the most favorable one) may be utilized in any taxable year. There is a further limitation under the student's and teacher's provisions as to tacking years together.[420]

H. *Additional Personal Deduction*

Since the late 1940's, a strange provision has governed the taxation of American businessmen in France. In view of the declared fact that these persons received greater salaries than would otherwise be the case, due to the increased cost of living, traveling, and maintaining two residences, the French Government promised to

414. OECD Draft, art. 17.

415. OECD Draft Commentary 134.

416. See text accompanying notes 109-204 supra.

417. S. Exec. Rep. No. 4, 79th Cong., 2d Sess. 3 (1946), S. Exec. Doc. F, 79th Cong., 2d Sess. 2-3 (1946).

418. 1967 Convention, art. 21(1).

419. Id., art. 21(2).

420. See text accompanying note 392 supra.

proceed in a liberal spirit . . . to examine each particular case in order to establish, if necessary before the establishment of the American companies in France, exactly what will be the situation of their personnel with regard to the Schedular Tax on salaries and wages (having regard in particular to the importance of the professional expenses the deduction of which might be authorized in the computation of the tax).[421]

The practical effect of this provision has been the allowance of a special deduction of 20 percent of the income earned in France for the supposed extra expenses of travel, living, and maintaining two residences. No other nation enjoys such a privilege. The United States secured it when it was prosperous and France lay prostrate from the havoc of World War II. This provision has been eliminated from the new convention,[422] since the justifications therefore—the encouragement of United States investment in France in pre-Marshall Plan days, and the establishment of allowances for extraordinary French living costs occasioned by post-war shortages—have long since vanished. In fact, the present policy of the United States and France is to try to discourage direct American investment in France. Furthermore, as the note establishing the deduction set forth, most United States citizens had been receiving a greater than normal salary to compensate for any additional expenses. Most corporate employees also had generous expense allowances. Moreover, the present exclusion of the first $20,000 earned from gross income if the individual is outside the United States for five hundred and ten days during an eighteen month period[423] also eases the financial problem of living abroad. Finally, the special deduction goes far beyond the principles of national treatment and nondiscrimination to provide a tax boon for citizens of one particular foreign country. Its elimination is therefore welcome, and may reduce some friction between the two countries.

I. *Imputed Income From Rentals*

The domestic law of France provides for a type of minimum tax. An individual who is not domiciled in France, but who possesses one or more residences in France, is taxed on the higher of his actual income from French sources or five times the rental value of his French residences[424]

421. S. Exec. Rep. No. 7, 80th Cong., 2d Sess. 7 (1948); Third Tax Convention 210.

422. No mention of this change is found in the legislative history, but an exchange of notes between Ambassador Bohlen of the United States and Secretary General Alphand of France makes it clear that the notes, minutes, and arrangements between the two countries with respect to prior tax conventions are abrogated. The specific mention that arrangements with respect to motion picture royalties are not thereby changed should add a negative implication, if any is needed, that unmentioned provisions are also changed. S. Exec. Doc. N, 90th Cong., 1st Sess. 19 (1967).

423. Int. Rev. Code of 1954, § 911(a)(2). Chommie § 241, at 601.

424. France § 11/3.9b. This is a very different kind of tax than that proposed by some commentators on imputed income from owner-occupied residences. The theory of such a

on the ground that most people spend 20 percent of their income for housing.[425] The new convention prohibits the imposition of such a tax on presumed income by either country,[426] and will be urged wherever appropriate by the United States in future tax convention negotiations.

VI. Prevention of Double Taxation

Since France does not tax all the income of its residents and corporations, it has encountered problems of double exemption under tax conventions that it has negotiated with other countries. Where income is exempt from tax in the source country, and France does not impose a tax on that income either, the income is therefore subject to no tax. In order to rectify this situation, France adopted a rule which provides that despite the lack of any taxing provision in the French Code, all income, the taxation of which is attributed to France by a tax convention, is taxable in France.[427] The new convention provides that this rule of law shall not be applied to United States residents.[428] Double exemption is unlikely to occur, as the United States taxes the world-wide income of its residents. Although the clause is couched in reciprocal language, the United States has no such rule. A tax convention may not increase the taxes imposed by the United States under present rules.[429]

A. *United States*

The United States may generally tax its citizens and residents as though the new convention had not been signed.[430] This is due to the general savings clause found in all United States tax conventions. To this clause there are numerous exceptions. If there were no exceptions, the negotiation of a tax convention would be futile. The savings clause does not apply to social security payments or to the provisions of the nondiscrimination provision.[431] Thus, United States residents receiving social security payments from France need not include them in their gross income. The savings clause also does not apply to students or teachers other than citizens of the United States or persons with immi-

proposed tax is that income is actually earned from such occupation and should be included in the tax base. W. Vickrey, Agenda for Progressive Taxation 18-19 (1947).

425. France § 11/3.9b, at 772 n.215.

426. 1967 Convention, art. 23(3).

427. France § 11/4.18.

428. 1967 Convention, art. 22(3). See S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 38 (1968); S. Exec. Doc. N, 90th Cong., 1st Sess. 20 (1967). The old convention contained no such provision since the rule was incorporated into French domestic law in 1959.

429. Of course, it is theoretically possible for a self-executing treaty to amend a statute so as to impose a United States tax, but this author knows of no instance in which it has occurred.

430. 1967 Convention, art. 22(4)(a).

431. Id., art. 22(4)(a)(i).

grant status in the United States.[432] The exclusions for individuals who have immigrant status in the United States is an attempt to confine convention benefits to persons who were, before they began their study, and will be, after they complete their study, residents of France. The savings clause is also not applicable to the governmental functions provision with respect to an individual not a citizen of the United States and who does not have immigrant status, and an individual with immigrant status who elects to claim the benefits of the governmental functions provision. In that case, the person may not use the years of benefit toward residence in the United States that is required for naturalization.[433] This provision is designed to cope with United States rules on residency, which provide that when an alien is present in the United States without intending to leave at a particular time, he is a resident of the United States.[434] The length of time spent in the United States may be significant in determining the intent of the alien. This would make most employees of the French government in the United States residents of the United States and thus not entitled to the benefits of the convention. In order to preserve these convention benefits, an exemption to the savings clause has been made. The special exemption for persons on immigrant visas has been added to accomodate certain French citizens who are present in the United States on this type of visa. They are permitted either the tax benefits of the convention or the right to accrue that residency for naturalization purposes.[435] The rationale behind the rule is that any person who is planning to become a United States citizen should not gain benefits accorded only to foreign residents.

The United States will allow its citizens and residents credit for income tax paid to France. The credit shall be based on the amount of French tax paid but shall not exceed that portion of the United States tax which net income from sources within France bears to the total net income.[436] This continues the provisions of the 1945 Convention,[437] which generally required some type of credit along the lines traditionally provided by United States domestic law.[438] The intention of the provision in the 1967 Convention is to specify the general method of relief without tying the United States to any particular provisions, such as the per-country limitation or the overall limitation.[439] The new convention specifies the per-country limitation, but not as an exclusive method of relief.

432. Id., art. 22(4)(a)(ii).
433. Id., art. 22(4)(a)(iii); see S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 38 (1968).
434. Treas. Reg. § 1.871-2(b) (1960).
435. S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 38 (1968).
436. 1967 Convention, art. 23(1).
437. 1945 Convention, art. 14(A).
438. Int. Rev. Code of 1954, §§ 901-05.
439. S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 39 (1968).

B. *France*

France has traditionally utilized only the exemption method for relieving double taxation. This results in considerably less unilateral relief from double taxation than that which the United States provides. For example, a French citizen and domiciliary is subject to French tax on his income from both French and foreign sources.[440] However, he may take a deduction for foreign taxes paid on income from foreign sources.[441] Thus, the tax is levied on his net income from abroad. This means that, in the absence of a tax convention, the French individual pays full foreign taxes on all his foreign income, and almost full domestic taxes.

In the 1967 Convention, there is slightly more unilateral relief for corporations than for individuals. Business income earned by foreign branches and permanent establishments of corporations resident in France is not subject to corporate tax.[442] An exemption is also given for income derived from foreign real estate,[443] interest,[444] royalties,[445] and capital gains,[446] if they are connected with the activities of such permanent establishments. Income from foreign joint ventures (but not partnerships) is likewise excluded from the corporation tax.[447] Thus, French corporations are subject to tax in France on income earned in France, and on foreign income not effectively connected with a permanent establishment located outside of France. These provisions, in themselves, constitute a substantial deterrent to French individuals and corporations making portfolio investments outside of France, as they will be subject to both French and foreign taxes.

Under the new convention, France avoids double taxation of income by a combination of the exemption and credit methods. Where income is taxable in both countries under the convention, France will allow its residents credit for United States tax paid on United States source income up to the amount of French tax levied on such income.[448] Income taxable in the United States which is not taxable in France by virtue of a tax convention shall be exempt from French taxation.[449] However, French tax may be computed on income taxable in France at the rate appropriate to the total of the income chargeable under French domestic

440. France § 11/1.2b.
441. Id. §§ 11/2.8e & .11a.
442. Id. § 11/2.4a, at 716.
443. Id. § 11/2.7a.
444. Id. § 11/2.8a, at 734.
445. See id. § 11/2.9, at 738-39. But royalties are considered to arise from the development of the patent, not its use. Id.
446. Id. § 11/2.10b, at 739-40.
447. Id. § 11/2.13, at 742.
448. 1967 Convention, art. 23(2)(b).
449. Id., art. 23(2)(a).

law.[450] This means that in determining the rate bracket of the income that is taxable under the progressive system in France, the total of the income earned by the resident may be included. It will be considered to come off the bottom brackets, rather than the top brackets, in its exemption from French tax.

While the United States relief from double taxation only restates its domestic law, France provides substantial relief which the United States will seek from other convention partners whose unilateral provisions are not as comprehensive as those of France.

C. *Nondiscrimination*

The nondiscrimination provision of the 1967 Convention is yet another instrument for avoiding double taxation. It applies to all taxes levied by the contracting states and their political subdivisions.[451] There are three situations in which discrimination is prohibited. First, residents of a contracting state must not be subject to "more burdensome taxes" than other residents who are citizens of that state.[452] Whether the United States presently complies with this standard is quite doubtful. At present, there are many provisions of United States domestic law that apply only to its citizens. [453] All of these provisions should be available to United States residents who are French citizens under the new convention. The nondiscrimination provision would seem to apply only to individuals, since corporations are not citizens.[454] Second, a state may not tax a permanent establishment of a resident of the other country less favorably than it does a resident of its own country who carries on the same activities, except for the application of a branch profits tax.[455] This provision does not protect a corporation engaged in trade or business in the United States which does not have a permanent establishment here.[456] The United States may still levy its 30 percent tax on gross income that is not effectively connected with a United States trade or business.[457] Third, a corporation of a country whose capital is owned or controlled by a resident of the other country must not be more heavily burdened than a similar corporation owned or controlled by a resident of the country

450. Id., art. 23(2)(c).

451. See text accompanying notes 24-29 supra.

452. 1967 Convention, art. 24(1).

453. E.g., Int. Rev. Code of 1954, §§ 901(b), 911(a)(2), 931(a), 1303(b), 6013(a)(1) & 6851(d); see Foreign Tax ¶ IX/11F(1); Lidstone, Liberal Construction of Tax Treaties—An Analysis of Congressional and Administrative Limitations of an Old Doctrine, 47 Cornell L.Q. 529, 541-47 (1962).

454. Foreign Tax ¶ IX/11E(1).

455. 1967 Convention, art. 24(2). The source of this provision is Article 24(4) of the OECD Draft.

456. See Foreign Tax ¶ IX/11E(1).

457. Int. Rev. Code of 1954, § 881(a).

of incorporation.[458] Although the nondiscrimination clause in the 1945 Convention was not complex and did not specifically enumerate these possible instances of discrimination, it would have prohibited each one of the enumerated instances of discrimination.[459] Thus, the 1967 Convention represents only a change toward more specificity. There is no problem in the United States with the second or third requirements (other than the one set forth). Any discrimination would be against corporations owned primarily by United States citizens, such as controlled foreign corporations.[460] It might even be contended that this does not constitute unequal treatment of the corporation, since the additional tax is imposed upon the United States shareholder.[461]

The nondiscrimination clause is as yet unlitigated, and likely to continue in its present form. It would appear that some of the discriminations against nonresident aliens could easily be eliminated from United States domestic law by the promulgation of tax conventions.[462]

VII. Administrative Provisions

The administrative provisions of the 1967 Convention, in general, represent a triumph of substance over form. The substance in the new convention is similar to that found in the old convention, but the form is considerably more specific.

A. *Mutual Agreement Procedure*

The 1945 Convention provided that any taxpayer who demonstrated that the action of the contracting state resulted in double taxation could lodge a claim with his country, and the two countries would endeavor to reach an agreement to equitably avoid double taxation.[463] In addition, the old convention permitted the competent authorities to establish rules for the apportionment of business profits.[464] The new convention continues these provisions, but makes them more specific. For example, the resident who feels that he will be subject to double taxation may present his case to the state of his residence.[465] Thereupon, the competent authorities endeavor to agree on the resolution of any difficulties.[466] In

458. 1967 Convention, art. 24(3). Article 24(5) of the OECD Draft is the source for this provision.

459. 1945 Convention Protocol, art. V.

460. Int. Rev. Code of 1954, §§ 951-72.

461. Id. § 951(a)(1); OECD Draft Commentary 154.

462. See, e.g., Int. Rev. Code of 1954, § 6013(a)(1).

463. 1945 Convention Supplementary Protocol, art. 14.

464. 1945 Convention, art. 3.

465. 1967 Convention, art. 25(1).

466. Id., art. 25(2). Note the difference between this provision and the mandatory language of Article 3(3) requiring agreement. See text accompanying note 88 supra. Quaere whether there is any practical difference?

particular, they will reach agreement on three possible joint courses of action: (1) the same attribution of business profits to a resident and its permanent establishment in the other state;[467] (2) the same allocation of income between a resident and a related person;[468] and (3) the same determination of the source of particular items of income.[469] These provisions add no substance to the old convention, but their specification adds to the likelihood that the competent authorities will feel impelled to actually reach agreement.

The most important substantive change from the old convention is that when the competent authorities reach agreement, taxes will be imposed and a refund or credit shall be allowed in accord with the agreement.[470] This means that the statutes of limitation under the domestic laws of the contracting states will be disregarded.[471] This authorization is necessary in both the United States and France, because the fiscal authorities of both nations are prevented by law from making payments after the expiration of the statutes of limitation.[472] This provision is a step in the right direction. A further step is that contained in the OECD Draft: "More detailed rules and procedures for re-allocating income between related enterprises will be considered by the Fiscal Committee in its future work."[473] The drafters of this provision presumably took into account the experience of the United States with its regulations promulgated under section 482 of the Internal Revenue Code.[474]

B. *Exchange of Information*

The 1967 Convention provides that the competent authorities of the two contracting states shall exchange information for the purpose of implementing the convention and for the prevention of fraud or fiscal evasion with respect to income taxes. Such information may be exchanged either routinely or, in particular cases, upon request. The competent authorities shall agree on the list of information to be routinely furnished[475] and, in all probability, the following will be included: payments of dividends, interests, royalties, and annuities from United States persons to persons with French addresses who have secured the reduced withholding rate under the convention's withholding regulations and

467. 1967 Convention, art. 25(2)(a).

468. Id., art. 25(2)(b).

469. Id., art. 25(2)(c). These provisions first appeared in the German Convention, art. XVII(3).

470. 1967 Convention, art. 25(4).

471. Hearings 35.

472. France § 13/7; Int. Rev. Code of 1954, § 6511(b)(1).

473. OECD Draft Commentary 12.

474. Treas. Reg. § 1.482-1 to -2 (1968).

475. 1967 Convention, art. 26(1) & (3).

personal service income where exemption from withholding has been secured.[476] However, it is unlikely that the income reported by French permanent establishments in the United States will be transmitted as a routine matter.

In exchanging information neither contracting state shall be required to carry out administrative measures which are not permitted in both states, to supply particulars not obtainable in both states, or to supply information which would disclose trade or public secrets.[477] Thus, the exchange of information is limited to the lowest common denominator of information that would be available to the fiscal authorities of both states if they had jurisdiction over the particular individual possessing the information. This is a somewhat more stringent requirement than existed under the old convention. Under that convention, one contracting state was not required to supply particulars not procurable under its own domestic law, but there was no right to refuse to supply information not procurable by the domestic law of the recipient state.[478] Furthermore, there was a specification of the material that would be supplied in the ordinary course relating to both income and estate taxes. In particular, the following information with respect to income taxes would have been supplied under the old convention: information on persons with an address in France deriving rents, dividends, interest, royalties, income from trust, salaries, wages, bonuses, pensions, annuities, or other fixed or determinable periodic income from sources within the United States,[479] and particulars relating to assets belonging to persons with French addresses that could have been obtained from banks or similar institutions.[480] The first class of items constitutes the income upon which withholding is required under United States domestic law.[481] France will transmit virtually the same information to the United States under the new convention.[482] These items of information will probably continue to be furnished automatically. It is particularly easy for the United States to transmit these items of information, as the withholding lists are now on magnetic tape in many cases. In this area, development by the OECD of a common form for reporting routine exchange items would be a useful project for it to undertake.

The new convention also provides for the non-routine exchange of information in particular cases.[483] No regular procedure has been estab-

476. Third Tax Convention 211.
477. 1967 Convention, art. 26(2).
478. 1945 Convention Supplementary Protocol, art. 8(2).
479. Id., art. 9(1)(a).
480. Id., art. 9(1)(c).
481. Int. Rev. Code of 1954, §§ 1441(a) & 1442(a).
482. 1945 Convention Supplementary Protocol, art. 10(3).
483. 1967 Convention, art. 26(3).

lished for this type of exchange. This type of provision has been used quite sparingly as the United States receives less than one hundred specific requests a year, with more than one-half of these coming from Canada.[484]

C. *Assistance in Collection*

In most cases, there is little problem in collecting taxes from persons abroad.[485] When a taxpayer resisted payment and the country desiring payment was a convention partner, the United States could have invoked the assistance in collection provision of the old convention.[486] The new convention makes no change in this article, which provoked a considerable dispute the last time it was considered, and, as a result, was somewhat watered down at that time.[487]

The contracting states under the new convention promise to lend assistance to each other in the collection of taxes on income (including interest, cost, and non-penal fines) where the taxes are definitely due under the law of the state making the request.[488] However, no assistance will be provided with respect to citizens or corporations of the state upon whom the request is made.[489] This exception was added from fear that the full panoply of United States collection measures, including jeopardy assessments, would be imposed after a foreign determination (either provisional or final) that might not comport with United States standards of due process and under procedures unfamiliar to United States persons.[490] Especially objectionable was the fact that the United States government would have no discretion as to whether the particular enforcement method should be applied in any individual case,[491] as it does under its domestic law.[492] This objection could easily be cured by redrafting the clause. The exclusion of citizens and corporations of the United States from the provision demonstrates chauvinism. However, it

484. Interview with Henry Driscoll, Office of International Operations, Internal Revenue Service, June 3, 1969.

485. For a good summary of the reasons, see Whitman, Tax Collection from Estates of Nonresidents, 68 Colum. L. Rev. 1049, 1051-52 (1968).

486. It has been contended that this provision has fallen into complete desuetude. 77 Harv. L. Rev. 1327, 1330 (1964).

487. S. Exec. Rep. No. 7, 80th Cong., 2d Sess. 1-9 (1948).

488. 1967 Convention, art. 27(1).

489. Id., art. 27(5).

490. Hearings on Exec. Doc. A Before the Subcomm. on the Convention with France on Double Taxation of the Senate Comm. on Foreign Relations, 80th Cong., 1st Sess. 33-34, 38-39, 41, 45, 73, 115-17, 167-68 (1947).

491. Id. at 34, 38-39, 116, 168.

492. This interpretation is gathered from the use of the directory word "will," which requires the Internal Revenue Service to use its complete collection arsenal in every case. If the word "may" were used, some administrative discretion would be retained.

does not demonstrate concern for arriving at a workable clause. It can be contended that citizens and corporations of France cannot complain of unfair French procedures, but what of their juxtaposition with more stringent United States enforcement?[493] Furthermore, what of citizens and corporations of third countries? If the convention provision is subject to abuse, it is more likely to be abused with respect to foreigners.[494] The exception, of course, largely negates the effectiveness of the provision, though it can still be used with regard to French citizens residing in the United States.

A second exception, of relatively little significance, confines the assistance in collection provision only to taxes covered by the convention.[495] This would exclude such taxes as turnover taxes,[496] employer's taxes,[497] local taxes,[498] various excise taxes,[499] the gift tax,[500] and certain registration taxes.[501] The succession tax is covered by an identical provision found in the estate tax convention between France and the United States.[502]

The 1967 Convention does not contain the clause usually found in tax convention collection provisions, which permits each country to refuse enforcement for reasons of public policy.[503] However, the lack of such a clause does not seem to have resulted in more enforcement than in conventions having such a clause.[504]

The new convention specifically provides two different types of assistance, based on the status of the claim. If the claim has not been finally

493. Hearings 73.

494. Note, International Enforcement of Tax Claims, 50 Colum. L. Rev. 490, 495 (1950), claims that the discrimination against citizens and corporations is necessary to avoid destroying the provisions, and is justified because each country must take care of its own citizens. The first contention is inaccurate, since it will only be by chance that a citizen of a third state will be caught; the second contention is more cynical than rational.

495. 1967 Convention, art. 27(1). Some tax conventions with the same wording are further limited by reservations to the conventions made by the United States Senate. The purpose of the reservations was to assure that the exemptions or rate reductions were not abused. E.g., South Africa Protocol, art. VIII, supplementing, South Africa Convention, art. XV.

496. See generally France §§ 14/1.1-4.1.

497. See generally id. §§ 4/2.1-.7.

498. See generally id. §§ 14/4.1-15/5.7.

499. See generally id. §§ 4/3.1-15.

500. See generally id. §§ 3/3.1-.2.

501. See generally id. §§ 3/4.1-.6e.

502. See generally id. §§ 3/2.1-.10. The administrative provisions of the old convention applied to both the income tax and estate tax convention. They are terminated by the 1967 Convention only to the extent that they relate to the income tax convention.

503. See, e.g., United Kingdom Convention Supplementary Protocol, art. XIXA(2). For a discussion of its significance, see Note, International Enforcement of Tax Claims, 50 Colum. L. Rev. 490, 499-500 (1950).

504. Assistance in collection has generally been confined to a letter of inquiry from the Internal Revenue Service. Interview with Nathan Gordon, Director, Office of Int'l Tax Affairs, Dep't of the Treasury, May 26, 1969.

determined, the conservatory provisions will be used.[505] On the other hand, if the claim has been finally determined, the full collection facilities will be used.[506] This requires in each case a definition of the term "finally determined." The best interpretation of the term would be to require that the case be settled beyond appeal in the foreign country, either by decision of its highest court or administrative body capable of hearing the case, or by expiration of the time for appeal or the applicable statute of limitations.[507] To take the view that a non-final administrative assessment is a final determination is nonsensical. Until the assessment becomes final, the provisions for conservancy should be sufficent to secure the payment of the tax. This view is strengthened by the fact that in both contracting states, there are procedures for securing a final determination of the entire controversy before the tax need be paid.[508] The new convention, in addition, mandates the full use of the jurisdiction's power to collect the tax. This will generally include resort to both the judiciary and administrative measures.[509]

Although the available assistance in collection provisions have rarely been used, they serve to provide tools that will be available in case of later need. The very existence of such provisions may also encourage voluntary cooperation. It is likely that a stronger clause could be secured by making enforcement discretionary with the requested country and by formulating a policy statement as to the types of circumstances (for common cases) in which the Treasury Department would exercise such discretion. The fact that these changes, which would make a stronger provision acceptable to the Senate, have not been made probably indicates that the problem, in practice, is not pressing.

D. *Exchange of Texts*

The new convention adds a provision that requires the competent authorities to exchange texts of any changes in the domestic tax laws covered by article 1[510] and any published material interpreting the con-

505. 1967 Convention, art. 27(4).

506. Id., art. 27(2).

507. Contra, Note, International Enforcement of Tax Claims, 50 Colum. L. Rev. 490, 498 (1950).

508. France § 13/4.4b.

509. For a discussion of French possibilities, see France § 13/10.1, at 951. For a discussion of United States procedures, see Note, International Enforcement of Tax Claims, 50 Colum. L. Rev. 490, 500-04 (1950). One of the limitations on enforcement of foreign judgments normally is the rule on recognition of foreign judgments used in the enforcing state. Id. at 496-97.

510. 1967 Convention, art. 30(1). No information need be exchanged with respect to taxes covered by the convention but not specified in Article 1. See notes 15 & 16 supra and accompanying text. Nor does it appear that copies of legislative hearings or legislative committee reports need be exchanged, as the clause only specifies "texts of amendments or new statutes."

vention.[511] This requirement will no doubt be fulfilled by the United States by sending the Internal Revenue Bulletin to France, along with any judicial decisions relating to convention interpretation.[512] While this provision will be useful, it would be more useful for each contracting state to undertake the preparation of an annual memorandum to the other contracting state setting forth all changes in its domestic law and convention interpretation that would be of significance to the convention partner. This would eliminate the necessity of going through a mass of material to find appropriate provisions, and then trying to determine their significance in the context of the other country's domestic tax law. Although most foreign tax administrations lack the personnel to comply with such a provision, the United States does not. Indeed, most of the convention partners of the United States are not religious in supplying the required documents.[513]

E. *Extension and Change of the Convention*

As to extension, the new convention contains provisions that would permit its extension to overseas territories of France.[514] The new convention also contains provisions which permit minor changes in the convention that conform to its spirit and changes in the internal law of one or both of the contracting states to be effectuated by an exchange of notes, rather than by a supplementary convention.[515] The Senate Foreign Relations Committee had been informed, prior to the promulgation of the new convention, that in the past, when there had been territorial extensions by exchange of notes, the extension had been submitted to the Senate for its approval, and that the same procedure would be followed in case of similar changes under the new convention.[516] This information satisfied neither the Foreign Relations Committee[517] nor the full Senate, since that body made approval by it of convention changes or convention extension by exchange of notes a specific requirement of its approval of the 1967 Convention.[518]

511. 1967 Convention, art. 30(2). Presumably this provision, no matter how persuasive, would not qualify. The clause reads: "shall exchange the texts of all published material interpreting the present Convention under their respective laws, whether in the form of regulations, rulings, or judicial decisions." This seems to exclude nonofficial writings. The reference to rulings should be sufficient to include revenue procedures and technical information releases.

512. Interview with Mr. Harold Warrington, Office of International Affairs, Internal Revenue Service, June 3, 1969.

513. Id.

514. 1967 Convention, art. 29(1).

515. Id., art. 30(3).

516. S. Exec. Rep. No. 5, 90th Cong., 2d Sess. 40-41 (1968).

517. Id. at 5.

518. 114 Cong. Rec. 16,166 (1968).

VIII. Conclusion

This article has attempted to analyze the provisions of the 1967 Convention, particularly those provisions that are likely to be utilized in subsequent income tax conventions negotiated by the United States. Therefore, it is appropriate to summarize the particular types of provisions that are likely to continue in our treaty relations with other countries, and to suggest areas where the treaty clauses could be improved.

Some of the provisions of the 1967 Convention were inserted solely because of a specific provision of French law or strong French public policy. Thus, the special provision relating to the branch profits tax,[519] and insurance agencies as permanent establishments,[520] are not likely to be repeated in future tax conventions.

The 1967 Convention was the first full new tax convention negotiated with a developed country after approval of the OECD Draft. In general, the new convention conforms to that document. In particular, the substance of the OECD Draft is incorporated even where its particular terms are not. Deviation from the OECD Draft occurs particularly where that model is silent or ambiguous.[521] The 1967 Convention supplies interpretation and specificity in many areas, and will be a model for the future.

The 1967 Convention is less successful in dealing with the interrelationship of the United States with a country using an integrated tax system for dividends where the relief is given through a credit to the shareholder. Originally, the convention provided almost no relief by adhering to the provisions of the OECD Draft, which are not designed to meet this situation. A later amendment provided relief for United States shareholders of French corporations, thereby eliminating part of of the discrimination. However, no relief was provided for French shareholders of United States corporations which would put them on a par with their brethren holding shares of Gallic firms. This was due partly from French reluctance to encourage the investment of French capital abroad, and partly from the novelty of the solutions required to achieve neutrality.[522] Whichever reason underlies the situation, an improved method is needed for dealing with integrated tax countries. Fortunately, there are few countries with integrated tax systems.

Matching the United States credit method of relief from double taxation with the French exemption method was not difficult. France was willing to accept a convention system based largely on the credit sys-

519. See text accompanying notes 232-60 supra.

520. See text accompanying notes 184-88 supra.

521. See, e.g., text accompanying notes 50-51 & 155-58 supra.

522. See text accompanying notes 270-85 supra.

tem.[523] Other countries in the future may not be so obliging. In addition, French domestic law provides that where taxing jurisdiction is allocated to France by convention, domestic taxing jurisdiction will expand to include items otherwise exempted from French tax.[524] Thus, the intersection of the credit and exemption methods does not produce *lacunae* that might otherwise result in fiscal evasion.

Perhaps the most significant change in the 1967 Convention is the taxation at source of royalties up to a limit of 5 percent.[525] A number of foreign countries have unfavorable balances of royalties payments with the United States. If every country whose balance was as poor as France insisted on source taxation of royalties, this would immediately become a general principle in United States tax conventions. While this would bring the taxation of royalties into line with principles used for taxing interest, it represents a substantial change that affects a great deal of revenue.

A second important achievement of the 1967 Convention is the incorporation of motion picture royalties within the definition of business profits.[526] The Convention will permit the movie industry, which earns large sums abroad, to arrange its business in an advantageous tax fashion. The United States will press for a similar provision in all future tax conventions and cite as precedent the 1967 Convention.

In addition to the benefits afforded the contracting parties, the 1967 Convention will serve as a model for the drafting of future conventions and provide a standard for their interpretation.

523. See text accompanying notes 427-50 supra.

524. France § 11/4.18, at 843.

525. See text accompanying notes 322-27 supra.

526. See text accompanying notes 112-21 supra.