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RECENT DEVELOPMENT


I. INTRODUCTION

On December 29, 1976, the French Government enacted a new Finance Law which would subject U.S. citizens residing in France with U.S. source passive income to double taxation. The New Law abolished Article 164(1) of the French Tax Code (Code General des Impots (CGI)). It liberalized the domiciliary requirements, eliminated the five-year "grade period" which


2. As used in this discussion, passive income is that income which is considered unearned (e.g. investment income such as dividends, interest and royalties). It does not, however, include income directly attributable to real estate (e.g. rents). For examples of what is considered as unearned income for U.S. tax purposes, see I.R.C. §§ 43(c)(2), 871(a)(1)(A).


4. CODE GENERAL DES IMPOTS (CGI) art. 164(1) which read:

Art. 164 — 1. Les contribuables de nationalité étrangère qui ont leur domicile en France sont imposables conformément aux règles édictées par les articles 156 à 163 quater. Toutefois, sont exclus de revenu imposable de ces contribuables les revenus de source étrangère a raison desquels les intéressés justifient avoir été soumis a un impôt personnel sur le revenu global dans le pays d' où ils sont originaires.

Sont considérés comme ayant leur domicile en France, pour l' application de la présente disposition, les étrangers ayant sur le territoire français le centre de leurs intérêts ou conservant leur résidence habituelle en France depuis plus de cinq ans.

5. New Law, supra note 1, art. II, which reads:

Sont considérés comme ayant leur domicile fiscal en France au sens de l'article 1er:

a. les Personnes qui ont en France leur foyer ou le lieu de leur séjour principal;

b. celles qui exercent en France une activité professionnelle, salariée ou non, à moins qu'elles ne justifient que cette activité y est exercée à titre accessoire;

c. celles qui ont en France le centre de leurs intérêts économique.
had been enjoyed by foreigners under prior law⁶ and provided that France would tax each French domiciliary on his worldwide income.⁷

The New Law provides that once an individual establishes a “domicile”⁸ for French tax purposes he will immediately become subject to French taxation on his worldwide income (as provided for in CGI Art. 156).⁹ As yet, no Protocol to the existing United States-France Tax Treaty¹⁰ been finalized and, in the absence of such, U.S. citizens residing in France who become domiciled there will face the possibility of double taxation on their U.S. source passive income.¹¹ This Note will discuss the New Law, in light of the old, and what effect it will have on U.S. citizens residing in France with passive U.S. source income.¹²

II. NEW DEFINITION OF DOMICILE

Since France's claim over an individual's worldwide income is based on whether or not he can be classified as a French domiciliary.¹³ Article II of the New Law, which provides a new test for determining an individual's domiciliary status, has become of great importance to those U.S. citizens residing in France with U.S. source passive income. Prior to the New Law, CGI Art. 164(1)¹⁴ had provided that an individual would be deemed a French domiciliary for French tax purposes if either his “center of interest” (centre d'intérêt) or “habitual residence” (résidence habituelle) was situated in France.

6. CGI art. 164(1).
7. New Law, supra note 1, art. I. The complete text of this provision reads:

Les personnes qui ont en France leur domicile fiscal sont passibles de l'impôt sur le revenu en raison de l'ensemble de leurs revenus.

8. The centering on one's “domicile” as a basis of establishing the right to tax the individual on his worldwide income is similar in principle to the taxation by the United States on the worldwide incomes of its “residents.” Residence for U.S. purposes is defined in Treas. Reg. § 1.871-1(b) (1977). Non-residents, as defined in Treas. Reg. § 1.871-1(a) (1977), are taxed on their U.S. source income, but the rate of tax depends on whether the income is deemed to be “effectively connected” with the conduct of a U.S. trade or business. I.R.C. § 871(a), (b) in connection with I.R.C. § 864(b), (c); see also note 84 infra. For purposes of French taxation, non-domiciliaries are taxed only on their French source income. New Law, supra note 1, art. V; see note 62 infra.

For examples of the differing concepts of “domicile” and “residence” for U.S. tax purposes, see Bergner & Engle Brewing Co. v. Dreyfus, 172 Mass. 154, 157 (1898).

9. New Law, supra note 1, art. II.


12. This discussion will assume that the tentative Protocol has been effected. See note 78 infra.
13. New Law, supra note 1, art. I, in connection with id., art. II. See notes 7 & 5 supra.
14. CGI art. 164(1); see note 3 supra.
Center of interests, as used in CGI Art. 164(1), denoted the center of an individual's "financial" interests.15 Personal interests were not determinative.16 Basically, the rule was if greater than fifty percent of an individual's gross income is derived from French sources, he shall be considered as domiciled in France under this test.17

An individual would also be deemed a French domiciliary if he had been habitually resident in France for a five-year period.18 Until 1968, habitual residence, for purposes of the five-year requirement of CGI Art. 164(1), had generally been read in light of CGI Art. 4,19 which defined an individual as habitually resident if either:

1) he had at his disposal, as an owner or tenant, a dwelling with a rental period of one year; or
2) his principal abode (séjour principal) was situated in France.

The principal abode test of CGI Art. 4 was generally considered to mean a stay of at least six months a year.20 In 1968, however, the Conseil d'État21 refused to read the provisions jointly.22 This reading of the Art. 164(1) test had created a particularly favorable position for the resident U.S. citizen, because it required that he be physically present in France for over six months each year for the five-year period before becoming classified as French domiciliary subject to French taxation. The Conseil d'État held,23 however, that the habitual resident test of CGI Art. 164(1) did not require the taxpayer's physical presence in France for over six months a year in each of the years during the five-year period; rather, the stay period should be interpreted more flexibly. In that case, the taxpayer had stayed in France less than six months in two of the five years (153 and 157 days respectively). The Court made no attempt, and refused requests to do so, to harmonize the conflicting habitual residence tests of CGI Articles 164(1) and 4.24 The confusion as to whether a six-month

16. 14 EUROPEAN TAX. at 434.
17. Id.
18. CGI art. 164(1); see note 4 supra and accompanying text.
20. 10 EUROPEAN TAX. at II/4. See note 19 supra.
22. Where a "principal abode" would establish the habitualness.
24. Id. In fact, it was the Government Commissioner who requested the harmonization of the conflicting "habitual residence" tests. Further, he urged that the "possession of a dwelling" test of CGI art. 4 be accepted as the better rule. However, the Court did not really consider this "test" in their final determination. Hence, as a "test," it is rarely employed.
physical stay will be required in order to establish a principal abode under the New Law and thus be considered a domiciliary, has yet to be resolved. It is likely to carry over to the New Law’s test, creating future interpretive and tax planning difficulties.

Yet, despite all the confusion, the requirements of CGI Article 164(1) worked to the advantage of those U.S. citizens who wished to live in France with U.S. source passive income. While they would establish an habitual residence by continuously residing in France, the five-year period still operated to protect that person from France’s jurisdictional claim over his worldwide income until the expiration of that period. Only then would the individual have established a domicile. During the five years, the individual’s passive income would be from non-French sources, thus keeping his center of interests outside France, and preventing him from being prematurely deemed a French domiciliary. This five-year foreigners holiday was one of the motivating factors in liberalizing the domiciliary requirements.

Article II of the New Law provides three means by which an individual will satisfy the new domiciliary requirements:

a) His home (foyer) or principal abode (séjour principal) is in France.

b) He exercises in France, whether as an employee or not, professional activities, unless they are secondary in nature (à titre accessoire).

c) The center of his economic interests is in France.

The impact of the article is to cause the U.S. citizen who is habitually resident in France to lose the benefits provided by the five-year grace period immediately.

A. Home

Under the New Law, residents of France immediately became classified as French domiciliaries if either their principal abode or their home was in France. The original text of the legislation provided that those individuals

25. The Court in its 1968 decision was attempting to distinguish between the two habitual residence tests (i.e. of CGI art. 164 and CGI art. 4). It determined that for purposes of the CGI art. 164(1) test, the principal abode “stay” requirement would be flexibly interpreted. It is unclear, though, whether the reasoning in this case providing for less than a six month physical presence to establish a principal abode for purposes of CGI art. 164(1), will be evaluated as a decision limited to the facts of the case, which is quite possible as both CGI provisions (i.e. 4 and 164(1)) which created the confusion have been repealed by the New Law. The New Law, art. II, refers to the principal abode of an individual, conspicuously omitting any reference to one’s “habitual residence,” thereby suggesting that the disturbance of the traditional definition of the phrase “principal abode” by the Conseil d’Etat in 1968, should be corrected. As no action on this issue has been taken to date, the scope of the term in the New Law remains of critical importance.

26. This would be the case for the individual who merely resided in France with U.S. source passive income. Obviously, the result would be different if the individual had French source wages, business or investment income. CGI art. 164(1).

27. As defined at note 15 supra and accompanying text.

28. See note 5 supra.

29. Under the habitual resident test of prior law.
whose "personal or familial home" was in France would be considered a domiciliary. Later drafts, presumably for the sake of clarity, modified the phrase to read simply as "home," which is taken to mean the place where his family resides. There do remain some interpretive concerns with the use of this term, since the present U.S.-French Tax Treaty uses the expression "permanent home" (foyer d'habitation permanent) and it has yet to be resolved whether these terms are equal in scope.

B. Principal Abode

The second means by which an individual establishes a "domicile" in France under the New Law is if he maintains his principal abode in France. Principal abode, as defined in its usual manner, is taken to mean a stay of greater than six months per year. However, with the abolishment of the five-year grace period, those U.S. citizens with their principal abodes in France will immediately be classified as domiciliaries, even though they may have established their principal abode in reliance on the five-year period.

C. Professional Activity

Article II of the New Law also provides that the exercising of professional activities in France may cause the individual to be deemed a French domiciliary for purposes of French taxation. This provision is limited to the extent that the "professional activities" must be of primary importance. The language of the statute creates the presumption of domicile and to rebut this,

30. 1976 Bulletin No. 6 INT'L TAX STRATEGY, June 1976, at 2. Personal home, as used in the earlier drafts of the New Law, has been distinguished from family home, in that for the former, the residence must have some type of permanent character for the individual, while the latter denotes the place where the family normally resides. "Home," as used in the final version of the law, seems more closely related to the definition of "family home," realizing that the purpose of the New Law is to tax those truly domiciled in France, and that most probably, the individual resides with his family. For discussion of the various usages of "home," see 16 EUROPEAN TAX. 400, 406 (1976).

31. 16 EUROPEAN TAX. at 406.

32. Id. at 406 n.42; see also note 30 supra.

33. Tax Treaty, supra note 10, art. III(3).

34. New Law, supra note 1, art. II (reproduced in note 5 supra).

35. But see notes 24 & 25 supra. The steadfast rule of six months, though, would not appropriately be employed when viewing the case of an individual who spends less than six months in France, but this period is longer than his stay in any other country. Regarding this, the reasoning of the Conseil d'Etat in the 1968 case, see note 19 supra, would correctly be applied. The Court in 1968 felt that the stay period of the habitual residence text of CGI art. 164(1), in connection with the habitual resident/principal abode test of CGI art. 4, should be flexibly interpreted. Depending on the importance of his "contact" with France, it may be possible for the individual who resides in more than two countries during the year, but a proportionately greater portion of his time is spent in France (even though less than six months) the "contact" with France should be sufficient to establish his principal abode in France.

36. See note 5 supra.
the individual must prove that the professional services he rendered were of secondary importance \( \text{à titre accessoire} \). The statute, however, does not define the scope of term \( \text{à titre accessoire} \) and it is here where the confusion must be resolved. For example, must the individual’s professional activities in France produce over fifty percent of his gross income or must the individual only render greater than fifty percent of his professional activities in France, regardless of the amount of income it produces in order to satisfy the statute’s requirements? These vagueness problems should be worked out prior to the effective date of the statute for U.S. citizens, but it is up to the French Parliament (or courts) to ultimately define the scope. Clearly, if fifty percent of one’s professional time is rendered in France producing greater than fifty percent of the individual’s gross income, the taxpayer would be considered as domiciled in France for tax purposes under the statute. It is where a lesser amount of time produces a greater percentage of one’s income and where a greater amount of time produces a minor portion of one’s total income that the need for clarification of the phrase \( \text{à titre accessoire} \) becomes a necessity.

D. Center of Economic Interests

The “center of economic interests” test is the same as the center of interests test under prior law; it is one’s “financial” interests that control.\(^{38}\) This test is met if greater than fifty percent of the individual’s gross income is derived from French sources. The new phrase, which modified the old to add the word “economic,” was intended to prevent the interpretive difficulties that manifested themselves with the simple use of the phrase “center of interests.”\(^{39}\)

Some of the problems found under the professional activities test may be resolved by applying the center of economic interests test and the principal abode test. If an individual renders less than fifty percent of his professional services in France, but the activity produces from French sources greater than fifty percent of his gross income, the center of economic interests test will deem that person a French domiciliary.\(^{40}\) In the alternative, if the individual spends greater than six months a year in France exercising professional activities, the principal abode test will deem him a domiciliary regardless of the amount of income generated by his professional activity.\(^{41}\) Professional activity in France seems to presuppose the resultant French source revenue, hence, investing capital abroad \( \text{\textit{i.e.}} \) outside France) would not be considered as rendering pro-

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37. A titre accessoire is literally translated as “an accessory title,” and is taken to mean an activity which is not the main activity of an individual.
38. See note 15 supra.
39. Id.
40. Id.
41. See note 35 supra.
fessional activities in France; nor would the individual's center of economic interests be situated in France in this circumstance.\textsuperscript{42}

Until the ambiguities of the professional activities test are clarified, an individual establishing himself in France (either on a temporary or permanent basis) could render his sideline business activities without being deemed a domiciliary provided (a) that the French source earnings would not exceed his non-French source worldwide gross income,\textsuperscript{43} and (b) that he does not exercise these activities \textit{a titre accessoire} for more than six months a year.\textsuperscript{44} However, with the scope of the term \textit{a titre accessoire} remaining as yet undefined, no amount of tax planning is secure.

E. Secondary Residence in France

It is possible for the U.S. citizen to maintain in France a secondary residence (e.g. a vacation home) without being deemed a French domiciliary. Article VII of the New Law provides that this individual would be subject to French taxation, but not above a minimum income level.\textsuperscript{45} This income is determined by three times the rental value of the residence, and the tax on this income would be based on the regular dividend rate.\textsuperscript{46} The individual would become obliged to pay this minimum income tax if he \textit{controls} the use of the residence,\textsuperscript{47} whether the control is based on ownership, lesseeship, or through a third party lending an apartment rented in his name to the individual for the individual's benefit.

F. U.S. Source Earned Income

Under the French worldwide taxation provisions,\textsuperscript{48} the U.S. citizen who establishes a French domiciliary, but continues to receive earned income from the United States, would be required to include this amount in calculating his French tax liability, thereby potentially placing him in a position of being doubly taxed on this U.S. source income.\textsuperscript{49} This possibility caused much con-

\textsuperscript{42} 14 EUROPEAN TAX., supra note 15, at 434 (where the Conseil d'Etat accepted the government's reasoning on this point); presumably, in the given circumstance, the same result would be reached.
\textsuperscript{43} To be shielded from the application of the center of economic interests test.
\textsuperscript{44} To be shielded from the professional activities test. Further, his stay period in France should be for less than six months; otherwise the principal abode theory might apply.
\textsuperscript{45} Prior law, CGI art. 164(2), had provided that the minimum income level would be based on five times the rental value of the residence.
\textsuperscript{46} Under provisions of the New Law, supra note 1, art. VII, the regular dividend rate as applied here is that found under CGI art. 197-1.
\textsuperscript{47} The original text of New Law, supra note 1, art. VII, reads, in part: "A quelque titre que ce soit, directement ou sous le couvert d'un tiers."
\textsuperscript{48} As provided for in CGI art. 156.
\textsuperscript{49} Assuming no Protocol is reached before the individual's French tax return for the taxable year 1979 must be submitted.
sation within the U.S. community in France. It now appears, though, that while any income earned as an employee by the U.S. citizen from U.S. sources will be computed in the determination of the individual's gross income for French tax purposes, the French will permit a full credit against its tax the amount of U.S. taxes paid. U.S. source business income will be exempt from French taxation and those sources of U.S. income which are covered specifically by the Treaty convention (real estate income, social security payments, and pension payments) will not be taxed in France. Presumably, the amount of this income will also be used in calculating the individual's marginal rate under the French tax laws.

G. Taxation of Non-Domiciliaries

Finally, the French will tax non-domiciliaries, not only on their minimum income, but also on any income derived from French sources. Article V of the New Law articulates some of the activities from which the income is considered as coming from French sources:

a) income from real property.


51. And presumably for the determination of the individual's marginal rate for French tax purposes. France's traditional method of relieving double taxation is "exemption with progression." According to the Explanatory Note from the U.S.-French Tax discussions, both sides agree that while business income from U.S. sources is exempt from French tax, the French will take such income into account for computing the individual's "progressive rate" on the income which is taxable by France. Explanatory Note on the United States' and France's tax discussions, 1976 Bulletin No. 12, INT'L TAX STRATEGY, Dec. 1976, at 18 [hereinafter cited as Explanatory Note].

52. The tentative Protocol agreement calls for this. Further, the salaried U.S. citizen in France will be taxed by France, but the proportion of the executives salary attributable (on a time basis) for work done in the United States will be exempt from French tax. See 1978 Bulletin No. 3, INT'L TAX STRATEGY, March 1978, at 6; see also 3 TAX MANAGEMENT INT'L J. 59 (1978). This credit treatment for foreign taxes on foreign source income (i.e. without France) is analogous to the U.S. treatment of similar types of income. See I.R.C. § 901. However, the resident alien in the United States is entitled to the benefits of I.R.C. § 911(a), providing he meets the standard set out in I.R.C. § 911(c).

53. "Business income," as used herein, refers to income from U.S. sources which the United States taxes as business income without regard to citizenship. Explanatory Note supra note 51, at 18.

54. Id.


56. Id., art. 5.

57. Id., art. 19.

58. Id., art. 20.


60. Id.; see also note 51 supra.

61. New Law, supra note 1, art. VII.

62. Id., art. V.

63. Id., art. V(a).
b) income from stocks and bonds of French corporations; \(^64\)
c) income from business activities exercised in France; \(^65\)
d) any income from employment if the activities are exercised \(^66\) in France. \(^67\)

### III. Loss of Foreign Income Exclusion

The New Law’s abolition of CGI Art. 164(1) has had the greatest impact on U.S. citizens residing in France with U.S. source passive income. \(^68\) CGI Art. 164(1) had permitted foreign residents of France to exclude from French taxation amounts received from non-French sources if they could prove that this income was subject to taxation in their country of nationality. \(^69\) This exclusion was available even after the foreign resident had established a domicile in France. Thus, this Article created a tax haven for the U.S. citizen in France with U.S. source passive income because even after the expiration of the five-year grace period the individual would be further protected under what amounted to a complete exemption from French taxation amounts received as investment income from U.S. sources. After January 1, 1979, \(^70\) this umbrella protection would be lost, thus subjecting U.S. citizens to French taxation on this income as soon as a “domicile” is established.

In the absence of a Protocol to the existing tax treaty between France and the United States, the abolition of CGI Article 164(1) will create serious double taxation possibilities for the U.S. citizen domiciled in France with U.S. source passive income. \(^71\) The root of the difficulty lies in the fact that the United States continues to tax the U.S. citizen on his worldwide income, New Law, \(^72\) supra note 1, art. XVI. This provision also repealed CGI art. 4. France will exercise her right to tax the French domiciled individual on his worldwide income, New Law, \(^73\) supra note 1, art. 1; see note 7 supra, and the United States continues to tax her citizens on their income, regardless of their domicile (even though the general provisions of I.R.C. § 911(a), (c)(1)(A) exclude the first $15,000 of earned income from taxation). The amount of this income, however, is used in computing the individual’s tax base (i.e. marginal rate). I.R.C. § 911(d). Both France and the United States agreed that the new French Finance law did not violate the terms of the existing Tax Treaty. Explanatory Note, \(^74\) supra note 51. This “exemption with progression” is similar to the French rule. See note 51 supra.

64. Id., art. V(b).
65. Id., art. V(c).
66. Id., art. V(d).
67. However, temporary employment by a non-French domiciliary is regulated by the terms of the Tax Treaty, \(^75\) supra note 10, art. 15(2).
68. For under prior law, even though a domicile in France had been established, the special provisions in CGI art. 164(1) had sheltered the U.S. citizens' foreign source income from French taxation. While the domiciliary requirements have been eased, it is the loss of the foreign income exclusion which will hit the pocketbook the hardest.
69. For the complete text of CGI art. 164(1), see note 4 supra.
70. New Law, \(^76\) supra note 1, art. XVI. This provision also repealed CGI art. 4.
71. France will exercise her right to tax the French domiciled individual on his worldwide income, New Law, \(^77\) supra note 1, art. 1; see note 7 supra, and the United States continues to tax her citizens on their income, regardless of their domicile (even though the general provisions of I.R.C. § 911(a), (c)(1)(A) exclude the first $15,000 of earned income from taxation). The amount of this income, however, is used in computing the individual’s tax base (i.e. marginal rate). I.R.C. § 911(d). Both France and the United States agreed that the new French Finance law did not violate the terms of the existing Tax Treaty. Explanatory Note, \(^78\) supra note 51. This “exemption with progression” is similar to the French rule. See note 51 supra.
72. Under the provisions of I.R.C. § 61(a), U.S. citizens are taxed on their gross income
from both countries met and announced their mutual interpretations "of treaty provisions which can effect American taxpayers in France." The United States agreed that the existing tax treaty did not prohibit the repeal of CGI Article 164(1), and that France's claim as the "country of residence" is consistent with the treaty. Subsection 5 of the Explanatory Note on the U.S.-French discussions states that both countries will cooperate to reduce double taxation possibilities. It provided further that France would permit the U.S. citizen to credit against his French tax liability the amount paid to the United States as taxes on his U.S. source passive income until a Protocol was arranged. This was intended only as a transitional measure and it is the intention of the French Government to ultimately claim jurisdiction over the worldwide incomes of those it deems to be its domiciliaries.

Both the United States and France have been working towards a Protocol agreement, but the approach has been a novel one for the United States. In addition to permitting a credit against U.S. taxes those amounts paid to a foreign state for income earned there, the tentative Protocol provides that:

"from whatever source derived." The term "source" includes not only the type of income derived, but the geographical location of where the income was produced. See McDaniel & Ault, infra note 84, at 36.

73. Explanatory Note, supra note 51.
74. Id. at 20.
75. Id. at subsection 5.
76. Presumably, the transitional period expires on the effective date of the statute (i.e. January 1, 1979) and the new rules will apply for the 1979 taxable year. New Law, supra note 1, art. XVI.

The mechanics of the proposed Protocol would work as follows:
a) In the case of France, a credit will be permitted against the tax imposed by France equal to the amount of tax which the United States could have imposed if the income had been received by a non-U.S. citizen. (Note: the amount of credit would not exceed the amount of French tax levied on the item of income).
b) The United States, so as to determine the amount of foreign tax credit available to the U.S. citizen for purposes of his U.S. tax liability on this income, will consider a portion of the income as U.S. source. This portion is determined by the ratio , where:

i) X equals the rate of tax which the United States could have imposed if the income was received by a non-U.S. citizen; and
ii) Y equals the effective yearly rate of tax which the United States imposes on the individual's gross income.

Income not included in this portion is to be considered as French source.

The new Protocol can best be articulated by the following example:

Assume a U.S. source dividend is received by the U.S. citizen in France, where the French rate of tax equals 60% and the U.S. rate of tax is 30%.

I. Gross Dividend $100.00
   French Tax (60%) $ 60.00
a) France will credit against taxes owed to France the amount of tax the United States could have imposed on the passive income\(^{79}\) (i.e. the withholding rate\(^{80}\) on dividends, 15 percent;\(^{81}\) interest, 10 percent;\(^{82}\) and royalty payments,\(^{83}\) five percent); and

b) the United States would deem a portion of the U.S. passive income as foreign source and would grant the U.S. citizen a credit against his U.S. tax liability the amount paid to France.

Never before has the United States permitted the private U.S. citizen to credit against his U.S. tax liability the amounts paid to a foreign state as tax on his U.S. source income.\(^{84}\) As a result, progress on the final ratification has been slow. The Internal Revenue Code, section 911,\(^{85}\) is defective in its treatment of U.S. source income either passive or earned, of a private U.S. citizen

<table>
<thead>
<tr>
<th>Credit for U.S. Tax</th>
<th>$15.00 (determined by treaty)</th>
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</thead>
<tbody>
<tr>
<td>Net French Tax</td>
<td>$45.00</td>
</tr>
</tbody>
</table>

II. U.S. tax on U.S. citizen at assumed overall effective rate of 30%

| $30.00 |

III. The ratio calculation would be as follows:

\[
\text{15\% (U.S. tax on non-U.S. citizen)} \times 100 = $50.00 \\
\text{30\% (U.S. tax rate)}
\]

This $50.00 is treated as U.S. source, with the remaining amount being considered as French source. The credit is limited to the U.S. tax on the deemed French source income (here, $15.00). The net U.S. tax liability, therefore, is $15.00 ($30.00 - $15.00), for a total tax liability of $60.00 ($45.00 + $15.00).

79. These types of income are specified in I.R.C. § 87(a)(1)(A); see also Treas. Reg. § 1.871-7(b) (1977).

80. Typically, the withholding rate on these types of income is a flat 30%. I.R.C. § 1441, in connection with I.R.C. § 871(a)(1). The Tax Treaty, however, reduced the percentage for certain types of income.

81. Tax Treaty, supra note 10, art. 9.

82. Id., art. 10.

83. Id., art. 11.

84. This same rule applies to aliens. Treas. Reg. § 1.871-1(a) (1977) provides that there are two classes of aliens: resident aliens, who are taxed in the same manner as U.S. citizens, id. § 1.871-1(a) (1977), and non-resident aliens, who are taxed either at a flat 30% rate, I.R.C. § 871(a), or at full U.S. rates, depending on whether the income is "effectively connected" with the conduct of a trade or business in the United States. I.R.C. § 871(b), in connection with I.R.C. §§ 864(b), (c). "Trade or business," as used in I.R.C. § 871(b) is somewhat analogous to the permanent establishment concept found in the Tax Treaty. The "effectively connected" income refers to income attributable to the permanent establishment. For a discussion of these connections, see P. McDaniel & H. Ault, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 153-55 (1977). If the income is effectively connected, it is taxed at full U.S. rates (i.e. between 14% and 70%). Treas. Reg. § 1.871-8 (1977). If it is earned income, the 50% maximum tax of I.R.C. § 1348 would apply. See generally B. Bittker & L. Ebb, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS (2d ed. 1968). If the income is passive, the rules of Treas. Reg. § 1.871-1(a) (1977) apply.

residing abroad. However, the Internal Revenue Code does permit the resident alien in the reverse situation\textsuperscript{86} to enjoy a credit against his U.S. tax liability for amounts paid to his country of origin as tax on his non-U.S. source income.\textsuperscript{87} In the opinion of some, the United States has historically ignored the internationally accepted principle that tax liability to a host country is superior to that of the country of citizenship.\textsuperscript{88} The new French Finance Law is in accordance with this intentionally accepted principle.  

IV. CONCLUSION  

The New Law will make it very difficult for an individual to settle in France without being deemed a French domiciliary, thus subjecting that individual to French taxation on his worldwide income. At a minimum, the owning of a secondary residence will subject the individual to a tax on a minimum income level.\textsuperscript{89} For the sake of the private business person who wishes to exercise multinational business activities, the ambiguities of the New Law must be clarified.\textsuperscript{90} It does appear that the burdens of double taxation will be relieved with a Protocol to the existing tax treaty on passive income from U.S. sources.\textsuperscript{91} Income that is derived from non-French and non-U.S. sources, however, may still be subject to double taxation because the tentative Protocol directs itself to the income which the United States could have levied a withholding tax upon. As it does not levy such a tax on non-U.S. source income,\textsuperscript{92} this income may not be considered as included under the Protocol.\textsuperscript{93}  

\textsuperscript{86} \textit{i.e.}, the French national "resident" in the United States for purposes of U.S. taxation with French source earned or passive income. Where the income is passive, the U.S. citizen domiciled in France for French tax purposes with U.S. source passive income has no available credit to offset his U.S. tax liability, but the U.S. resident French national does have such a credit under I.R.C. \textsection 901(b)(3) when his passive income is from French sources. Prior to the 1976 Finance Law, their respective positions were basically similar. The disparity in treatment results from the abolition of CGI art. 164(1) which had hitherto given the U.S. source income of the U.S. citizen in France preferential treatment. The same result as that found under prior law might have been reached had the French merely imposed a credit for U.S. taxes paid on this income (as does I.R.C. \textsection 901), although it appears that the Protocol agreement has done this with respect to U.S. source earned income in the hands of the U.S. citizen domiciled in France. See note 52 \textit{supra}. Taxed paid on foreign source income to a foreign state by a U.S. citizen may be credited against his U.S. tax liability, however, I.R.C. \textsection 901(b)(1).  

\textsuperscript{87} I.R.C. \textsection 901(b)(3); see also, Liebman, \textit{A Formula for Tax Sparing Credits In U.S. Tax Treaties With Developing Countries}, 72 AM. J. INTL L. 296 (1978).  


\textsuperscript{89} New Law, \textit{supra} note 1, art. VII.  

\textsuperscript{90} E.g., the professional activities test. See \textsection 11, C \textit{supra}.  

\textsuperscript{91} See note 78 \textit{supra}.  

\textsuperscript{92} The United States' power to withhold, for obvious reasons, extends only over that income which is derived from U.S. sources.  

\textsuperscript{93} Take for example the U.S. citizen "domiciled" in France for purposes of French taxation, who receives dividends from both U.S. and United Kingdom sources. Britain would not tax the dividends under terms of her treaties with France and the United States because certain statutory
Thus, the U.S. citizen may potentially be subject to double taxation on this income, although it is likely that some type of arrangement will be concluded.

As yet no Protocol has come into effect and the date for the termination of the French transitional period rules granting the U.S. citizen a credit for the U.S. taxes paid on the U.S. source passive income, as well as the effective date for the abolition of CGI Article 164(1), is January 1, 1979. The final ratification has been delayed by Congressional reticence to grant a credit against U.S. taxes for U.S. source income, as well as a delay in the receipt from France of the French version of the tentative Protocol. Once this is received it is probable that the Protocol will be enacted. It is hoped that this will be before the end of the expiration period although, as French income taxes are not due for the 1979 taxable year until after the close of 1979, the U.S. and French governments still have some time remaining to effect the Protocol agreement. As the tentative Protocol is near the final states of completion, however, it is probable that it will be in force by the end of 1979, and that double taxation will be avoided.

Thomas Carney

provisions enable a non-resident of Britain to exclude from British tax amounts received as dividends. Gomeche, Business Operations in the United Kingdom, 68-6th TAX MANAGEMENT A-99 (1976). France would include this income in the domiciliary's tax base, as would the United States, but because the U.S. did not withhold tax on any portion of the income (because it is foreign source), the U.S. citizen would have no available credit to offset his French tax liability on his income. However, as I.R.C. § 901 permits the aggregation of foreign taxes paid on foreign source income in order to determine the amount available as a credit, the taxpayer would be able to utilize a credit to offset his U.S. tax liability on this income, even though the taxes were not paid to the country of the income's origin.

94. New Law, supra note 1, art. XVI; see also note 76 supra.
95. New Law, supra note 1, art. XVI.
96. It has been very difficult to persuade the Congress that it should not fully tax the U.S. source income of a U.S. citizen, according to a spokesman at the International Tax Counsel’s Office, although it appears to have been resolved as ratification is expected. Informal telephone conversation with Marsha Fields, Esq., Attorney, U.S. Treasury Dep’t, Washington, D.C., (Nov. 2, 1978). Congress, who only recently in 1976 reduced the foreign earned income exclusion of I.R.C. § 911, see note 85 supra, has this year passed a law which permitted the U.S. taxpayer to extend prior law’s I.R.C. § 911 through the 1977 taxable year. According to the Wall Street Journal, “Beginning with the current tax year, most Americans overseas would be able to claim a variety of deductions based on the higher cost of living in foreign lands. In addition, employees living in so called ‘hardship areas’ — mostly underdeveloped countries — could claim an extra $5,000 deduction.” The Wall Street Journal, Oct. 17, 1978, at 16, col. 2.
97. As in the United States, individual taxpayers in France are required to declare after the close of the taxable year.

**Editor’s Note: The following Protocol was received just prior to publication of the Journal. It is reproduced here for the reader’s convenience.
PROTOCOL
TO THE CONVENTION BETWEEN
THE UNITED STATES OF AMERICA
AND THE FRENCH REPUBLIC WITH
RESPECT TO TAXES ON INCOME AND PROPERTY
OF JULY 28, 1967, AS AMENDED
BY THE PROTOCOL OF OCTOBER 12, 1970

The President of the United States of America and the President of the French Republic, desiring to amend the Convention between the United States of America and the French Republic with respect to taxes on income and property of July 28, 1967, as amended by the Protocol of October 12, 1970, have appointed for that purpose as their respective plenipotentiaries:

The President of the United States of America: The Honorable George S. Vest, Assistant Secretary of State for European Affairs, and

The President of the French Republic: His Excellency François de Laboulaye, Ambassador of France,

who have agreed upon the following provisions.

ARTICLE 1

1. In Article 1, paragraph (1) is replaced by the following:

"(1) The taxes which are the subject of the present Convention are:

(a) In the case of the United States, the Federal income taxes imposed by the Internal Revenue Code and the excise tax on insurance premiums paid to foreign insurers. The excise tax imposed on insurance premiums paid to foreign insurers, however, is covered only to the extent that the foreign insurer does not reinsure such risks with a person not entitled to exemption from such tax under this or another convention.

(b) In the case of France:

(i) the income tax, the corporation tax, including any withholding tax, prepayment (précompte) or advance payment with respect to the aforesaid taxes; and

(ii) the tax on Stock Exchange transactions."
2. Article 2 is amended as follows:

(1) Subparagraph (1)(a) of Article 2 is replaced by:

"(a) The term 'United States' means the United States of America and, when used in a geographical sense, includes the States thereof and the District of Columbia. Such term also includes any area outside the States and the District of Columbia which is, in accordance with international law, an area within which the United States may exercise rights with respect to the natural resources of the seabed and sub-soil.

The term 'France' means the French Republic and, when used in a geographical sense, means the European and Overseas departments of the French Republic. Such term also includes any area outside those departments which is, in accordance with international law, an area within which France may exercise rights with respect to the natural resources of the seabed and sub-soil."

(2) A new subparagraph (1)(e) is added, and the present subparagraph (1)(e) is renumbered (1)(f):

"(e) the term 'international traffic' means any transport by a ship or aircraft, except where such transport is solely between places in the other Contracting State."

3. Article 6 is amended by introducing the following new paragraph (4), the current paragraphs (4) and (5) becoming the new paragraphs (5) and (6):

"(4) A partner shall be considered to have realized income or incurred deductions to the extent of his ratable share of the profits or losses of the partnership. For this purpose, the character of any item of income or deduction accruing to a partner shall be determined as if it were realized or incurred from the same source and in the same manner as realized or incurred by the partnership. A partner will be considered to have realized or incurred a proportionate share of each item of income and deduction of the partnership, except to the extent that his share of the profits depends on the source of the income."

4. Article 7 is replaced by the following article:

"ARTICLE 7

Shipping and Air Transport

(1) Notwithstanding Articles 6 and 12:

(a) Where a resident of the United States derives income from the operation in international traffic of ships or aircraft, or gains from the sale, exchange or other disposition of ships or aircraft used in international traffic by such resident, such income or gains shall be taxable only in the United States.

(b) Where a resident of France derives income from the operation in
international traffic of ships or aircraft, or gains from the sale, exchange or other disposition of ships or aircraft used in international traffic by such resident, such income or gains shall be taxable only in France.

(2) The provisions of this Article shall also apply to the proportionate share of income derived by a resident of a Contracting State from participation in a pool, a joint business or an international operating agency. The proportionate share shall be treated as derived directly from the operation in international traffic of ships or aircraft.

(3) In the case of a corporation, the provisions of paragraphs (1) and (2) shall apply only if more than 50 percent of the capital of such corporation is owned, directly or indirectly:
   (a) by individuals who are residents of the Contracting State in which such corporation is resident or of a State with which the other Contracting State has a convention which exempts such income; or
   (b) by such Contracting State.

However, if more than 50 percent in value of the shares of a corporation or of its parent are listed on one or more recognized securities exchanges in a Contracting State, and there is substantial trading activity in those shares on such exchange or exchanges, then the provisions of paragraphs (1) and (2) shall apply if it can be shown that 20 percent or more of the capital of such corporation is owned, directly or indirectly, by individuals and the Contracting State specified in this paragraph.

(4) For the purposes of this Article, income derived from the operation in international traffic of ships or aircraft includes:
   (a) profits derived from the rental on a full or bareboat basis of ships or aircraft if operated in international traffic by the lessee or if such rental profits are incidental to other profits described in paragraph (1), or
   (b) profits of a resident of a Contracting State from the use or maintenance of containers (including trailers, barges and related equipment for the transport of containers) used for the transport in international traffic of goods or merchandise if such income is incidental to other profits described in paragraph (1)."

5. Article 10 is amended by adding a new paragraph (9) as follows:
   "(9) Notwithstanding the provisions of paragraphs (2) and (3), and subject to the provisions of paragraph (4), interest on any loan of whatever kind granted by a bank shall be exempt in the State in which such interest has its source."

6. Article 14 is amended by adding a new paragraph (4) as follows:
   "(4) Article 6, paragraph (4), shall apply by analogy. In no event,
however, shall that provision result in France exempting under Article 23 more than 50 percent of the earned income from a partnership accruing to a United States citizen who is a resident of France. The amount of such a partner’s income which is not exempt under Article 23 solely by reason of the preceding sentence shall reduce the amount of partnership earned income from sources within France on which France can tax partners who are not residents of France.”

7. In Article 15, paragraph (3) shall be amended as follows:

“(3) Remuneration received by an individual for personal services performed aboard ships or aircraft operated by a resident of a Contracting State shall be exempt from tax by the other Contracting State if the income from the operation of the ship or aircraft is exempt from tax in the other Contracting State under Article 7 and such individual is a member of the regular complement of the ship or aircraft.”

8. Article 20 is amended to read as follows:

“Article 20
Social Security Payments

Social security payments (whether representing employee or employer contributions or accretions thereto) paid by one of the Contracting States to an individual who is a resident of the other Contracting State or a citizen of the United States shall be taxable only in the former Contracting State.”

9. In Article 22, paragraph (4)(a) is amended by adding the following sentence immediately after the first sentence:

“For this purpose the term ‘citizen’ shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss.”

10. Article 23 shall be replaced by the following new article:

“Article 23
Relief from Double Taxation

Double taxation of income shall be avoided in the following manner:

(1) In the case of the United States: In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof) the United States shall allow to a citizen, resident or corporation of the United States as a credit against its tax specified in paragraph (1)(a) of Article 1 the appropriate amount of income taxes paid to France. Such appropriate amount shall be based upon 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 entire net income.”
(2) In the case of France:

(a) income referred to below derived by a resident of France shall be exempt from the French taxes mentioned in subparagraph (1)(b)(i) of Article 1:

(i) income (other than income referred to in paragraph (2)(b) of this Article) which is taxable in the United States under this Convention other than by reason of the citizenship of the taxpayer; and

(ii) in the case of an individual who is a citizen of the United States,

(a) income dealt within Articles 14 or 15 to the extent the services are performed in the United States;

(b) income which would be exempt from United States tax under Articles 17 or 18 if the recipient were not an individual who is a citizen of the United States;

(c) income dealt with in paragraph (1) of Article 19, to the extent attributable to services performed while his principal place of employment was in the United States.

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

(c) Notwithstanding the provisions of subparagraphs (a) and (b), French tax may be computed on income chargeable in France by virtue of this Convention at the rate appropriate to the total of the income chargeable in accordance with French law.

(3) In the case of an individual who is both a resident of France and a citizen of the United States:

(a) the amount of the tax credit referred to in subparagraph (b) of paragraph (2) shall be equal to the amount of tax which the United States would be entitled to levy in respect of the item of income if the individual deriving the income were not a citizen of the United States, but shall not exceed the amount of French tax levied on such item of income;

(b) the United States, in determining the amount of credit allowable for foreign taxes, shall consider as income from sources within the United States only that portion of each item of income referred to
in subparagraph (b) of paragraph (2) which is equal to the ratio of $X$ where:

(i) $X$ is the rate of tax which the United States would be entitled to levy if the individual deriving the income were not a citizen of the United States, and

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

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

(c) If for any taxable year a partnership of which an individual member is both a resident of France and a citizen of the United States elects, for United States tax purposes,

(i) any income which solely by reason of paragraph (4) of Article 14 is not exempt from French tax under this Article shall be considered income from sources within France; and

(ii) the amount of income to which subparagraph (i) applies shall reduce (but not below zero) the amount of partnership earned income from sources outside the United States which would otherwise be allocated to partners who are not residents of France. For this purpose the reduction shall apply first to income from sources within France and then to other income from sources outside the United States.

This provision shall not result in a reduction of United States tax below that which the taxpayer would have incurred without the benefit of deductions or exclusions available solely by reason of his presence or residence outside the United States.

(4) A resident of a Contracting State who maintains one or several abodes in the territory of the other Contracting State shall not be subject in that other State to an income tax according to an "imputed" income based on the rental value of that or other abodes."

ARTICLE 2

This Protocol shall be ratified and instruments of ratification shall be exchanged at Paris. It shall enter into force one month after the date of exchange of the instruments of ratification.
Its provisions shall for the first time have effect with respect to taxable years beginning on or after January 1, 1979.

ARTICLE 3

This Protocol shall remain in force as long as the Convention between the United States of America and the French Republic with respect to taxes on income and property of July 28, 1967, as amended by the Protocol of October 12, 1970, shall remain in force.

IN WITNESS WHEREOF, the respective plenipotentiaries have signed the present Protocol and affixed thereto their seals.

DONE at Washington in duplicate, in the English and French languages, both texts being equally authoritative, this 24th day of November, 1978.

For the President of the United States of America:
George S. Vest
Assistant Secretary of State for European Affairs

For the President of the French Republic:
François de Laboulaye
Ambassador of France

DEPARTMENT OF STATE
WASHINGTON

Excellency:

In connection with the Protocol signed today, I should like to state our understanding with respect to two important unresolved issues and certain other matters concerning the application of the Protocol.

1. The United States takes the position that the tax credit (avoir fiscal) available to French investors in French corporations should extend on a non-discriminatory basis to United States investors in French corporations. Under the terms of the Protocol signed in 1970 to the income tax convention between our two countries, the avoir fiscal is extended to United States portfolio investors. But in the absence of a similar extension to United States direct investors, the United States Government considers that the French tax credit system discriminates against investments made in France through the intermediary of a United States parent corporation, as compared to investments made by a French parent corporation.

We recognize the revenue concerns of France with respect to this issue and are prepared to accept, in the case of dividends from French subsidiaries to United States parent corporations, one half of the credit available to French shareholders less the 5 percent withholding tax at source allowed by the treaty (Article 9).

We are very concerned that the Government of France is not able to agree
at this time to extend one half of the *avoir fiscal* to United States direct investors. We have agreed to conclude the Protocol without such a provision only because the change in French tax law which takes effect January 1, 1979 would otherwise subject United States citizens residing in France to double taxation, and we do not want them to be so penalized. We appreciate, however, that the Government of France will continue considering this issue and agrees to reopen discussions on the subject of the *avoir fiscal* as soon as feasible, and in any event if the credit is extended in full or in part to direct investors of other countries.

His Excellency
François de Laboulaye
Ambassador of France

2. It is the position of the Government of France that the so-called “unitary apportionment” method used by certain states of the United States to allocate income to the United States offices or subsidiaries of French corporations, results in inequitable taxation and imposes excessive administrative burdens on French corporations doing business in those states. Under that method the profit of a French company on its United States business is not determined on the basis of arm’s length relations but is derived from a formula taking account of the income of the French company and its worldwide subsidiaries as well as the assets, payroll, and sales of all such companies.

For a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a United States state, in English, imposes a costly burden.

It is understood that the Senate of the United States has not consented to any limitation on the taxing jurisdiction of the states by treaty and that a provision which would have restricted the use of unitary apportionment in the case of United Kingdom corporations was recently rejected by the Senate. The Government of France continues to be concerned about this issue as it affects French multi-national corporations. If an acceptable provision on this subject can be devised, the United States agrees to reopen discussions with France on this subject.

3. The Explanatory Note issued by the French and American Governments will cease to have effect for periods to which this Protocol applies. With respect to the taxation of American residents in France under this Convention, the two governments have agreed that:

a. Contributions to pension, profit-sharing, and other retirement plans which qualify under the United States Internal Revenue Code will not be considered income to an employee and will be deductible from the income of a self-employed individual, to the extent that such contributions are required by the terms of the plan and are comparable to similar French arrangements;
b. Payments received by the beneficiary in respect of the plans referred to in (a) will be included in income for French tax purposes, to the extent not exempt under subparagraph (2)(a)ii)(c) of Article 23 of the Convention, at the time when, and to the extent that, such payments are considered gross income under the Internal Revenue Code;

c. Benefits received by reason of exercise of stock options will be considered compensation for French tax purposes at the time and to the extent the exercise of the option or disposition of stock gives rise to ordinary income for United States tax purposes;

d. United States state and local income taxes imposed in respect of income from personal services and any other business income (except income which is exempt from French tax under the Convention) shall be allowed as business expenses;

e. The French Government will attempt to reach a reasonable solution with American residents of France regarding the taxation of employer-provided benefits which are not considered income by the United States;

f. In applying the provisions of French law referred to by paragraph 2(c) of Article 23, the French Government clarified how the exemption with progression provision applies. The tax due is that proportion of the tax on total income which taxable (non-exempt) income bears to total (exempt plus taxable) income. For example, if a taxpayer has a total income of $20,000 of which by reason of this Convention only $12,000 is taxable by France, the French tax will be 60 percent (12,000/20,000) of the tax computed on a total income of $20,000.

If this is in accord with your understanding, I would appreciate a confirmation from you to this effect.

Accept, Excellency, the renewed assurances of my highest consideration.

GEORGE S. VEST  
Assistant Secretary  
for European Affairs