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Transfer Pricing: A Comparative Study of the French and U.S. Legal Systems

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VALERIE CIANCIA

Transfer Pricing: A Comparative Study of the French and U.S. Legal Systems.
(Under the Direction of DR. WALTER HELLERSTEIN)

For several decades, the number of multinational corporations has significantly increased and this phenomenon has created a new problem: the issue of transfer pricing. Indeed, national states have observed that multinationals could simply manipulate cross-border transfer pricing policies in order to shift profits from one jurisdiction to another. France, along with the United States, was one of the very first countries to introduce transfer-pricing legislations. Although the aims of the French and U.S. transfer pricing systems are similar, the means used to apply such rules are different and often raise difficulties to get rid of double taxations. Nevertheless, many solutions can be found in the 1994 tax treaty enforced between both countries, whose goal is the avoidance of double taxation and the prevention of fiscal evasion. The mutual agreement procedure and arbitration are two of the proposed alternative solutions.

INDEX WORDS: Transfer pricing, France, United States, Adjustment,
Cross-border Transactions, Multinationals

TRANSFER PRICING:
A COMPARATIVE STUDY OF THE FRENCH AND U.S. LEGAL SYSTEMS

by

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D.E.S.S., The University of Lyon 3, France, 2000

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CHAPTER 1

INTRODUCTION

The globalization of economies has led to the development of numerous multinational enterprises which include, either directly or indirectly, related entities. From an economic perspective, these groups of companies may play a substantial role with regard to international taxation. Indeed, multinational enterprises use cross-border parent subsidiary relationships to achieve greater efficiency, gain economies of scale, and exploit differences in national taxation rates. Thus in the international field, lower taxes can be achieved by allocating income to a taxpayer in a low-tax jurisdiction, or by providing a deduction to a company in a high-tax jurisdiction. This ability to reallocate profits leads us to the phenomenon known as “transfer pricing”. Transfer pricing is a tax technique used by related entities to shift profits from one jurisdiction to another in order to minimize their tax burdens. For example, a parent company in a high tax jurisdiction can avoid taxes by selling inventory at below market prices to its subsidiary located in a low tax jurisdiction. When the subsidiary sells the goods (as a reseller), the resulting income is taxed at the lower rate applying in the country where the subsidiary operates, and not the higher rate of the parent country. This artificially deflates the parent company’s profit, ultimately minimizing its tax burden.

For national governments, including the tax authorities, these internal transfer prices have become an increasingly important factor as the internal transfers within multinational corporations, of tangible and intangible goods, services and finance, have

become a major element in international trade and payments. As the existence of opposing interests that usually presides over the determination of the conventional provisions is lacking between related enterprises, transfer pricing of exchanged goods or services can be fixed without restraint, as intercompany relationships provide flexibility in methods of distribution and in control of production costs.¹

The question raised by transfer pricing established between members of a multinational group of companies has been one of the most sensitive issues in the area of international taxation for many years. The transfer pricing matter becomes a tax issue as authorities notice that multinationals could simply manipulate cross-border transfer pricing policies in order to shift profits from one jurisdiction to another. Economists have even argued that “the ability to manipulate transfer prices is a major reason for the existence of multinational enterprises.”² It is estimated that trading among such affiliates encompasses about one third of world manufacturing trade³, and that percentage is constantly increasing.

The Internal Revenue Service (herein after referred to as “IRS”) was then worried about international tax evasion and avoidance, as U.S. corporations controlled by foreign interests were suspected to pay less tax than those owned by U.S. investors. It is not surprising that tax officials are concerned about transfer pricing. The monetary amounts at issue in transfer pricing cases are often very large. A 1993 report indicated that \$9.9 billion in transfer pricing allocations was being litigated in various courts. Even though

¹ See Thomas Borstell, *A Special Report*, INT’L TAX REV. 4 (1997).

² Reuven S. Avi-Yonah, *The Rise and Fall of Arm’s Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89-90 (1995).

³ U.S. General Accounting Office, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices* 62-63 (1992).

such cases represented only .002% of the cases then pending in the Tax Court, they accounted for approximately one third of the amount being contested here.⁴

During his 1992 presidential campaign, then-candidate Clinton singled out the issue of transfer pricing abuse by claiming that he would collect an additional forty-four billion dollars through taxing of multinational corporations, alleging that the IRS under the Bush Administration had failed to collect this amount in taxes due from foreign investors in the United States who were avoiding taxes by transfer pricing manipulations.⁵ As a consequence, the IRS has established more precise and compulsory rules in terms of transfer pricing's control, especially through the modification of Section 482 by the Tax Reform Act of 1986.⁶

The general test is that transfers between related parties should be treated as though they were made at an arm's length price, i.e. a price that would be charged under the same circumstances between unrelated parties. Both the American and the French legislation apply this test and have developed rules in order to prevent illicit transfers of profits.

SECTION I: OVERVIEW OF THE U.S. TRANSFER PRICING SYSTEM

In the United States, primary regulation of intra-firm transfer pricing is accomplished under Section 482⁷ of the Internal Revenue Code and its regulations.

Section 482 provides:

⁴ 204 BNA Daily Tax Rep. G-7 (Oct. 25, 1993).

⁵ See Michael Avramovich, Note, *Intercompany Transfer Pricing Regulations Under Internal Revenue Code Section 482: The Noose Tightens on Multinational Corporations*, 28 J. MARSHALL L. REV. 915, 924-25 (1995).

⁶ Pub.L.No 99-514, 100 Stat. 2095 (1986).

⁷ 26 U.S.C. 482 (1999).

“In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary [of the Treasury] or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances, between or among them, if it determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses. In the case of any of transfer (or license) of intangible property, (within the meaning of section 936(h)(3)(B)), the income with respect of such transfer or license shall be commensurate with the income attributable to the intangible.”

History of Section 482

As early as 1917, the Commissioner of Internal Revenue could require related corporations to file consolidated tax returns “whenever necessary to more equitably determine the invested capital or taxable income”.⁸ The earliest direct predecessor of section 482 dates to 1921, when the Commissioner was authorized to consolidate the accounts of affiliated corporations “for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses”.⁹ This provision was apparently in reaction to concern in

⁸ Regulation 41, Articles 77-78, War Revenue Act of 1917, ch. 63, 40 Stat. 300 (1917). *See also The Globally Integrated Multinational, The Arm’s-Length Standard, and The Continuum Price Problem*, 13 TM-TPR S-3, Special Report, Nov. 1, 2000.

⁹ Rev. Act of 1921, ch. 136, s240(d), 42 Stat. 260 (1921). *See also* Reuven S. Avi-Yonah, “*The Rise and Fall of Arm’s-Length: A Study in the Evolution of U.S. International Taxation*”, 15 Va. Tax Rev. 89, 95-97 (1995) (discussing the legislative history of the 1921 Act).

Congress that taxpayers were able to use subsidiaries for manipulating the income of a domestic parent corporation.¹⁰

The Courts supported the logic of consolidation:

“The purpose of requiring consolidated returns was...to impose the war profits tax upon the true net income and invested capital of what was, in practical effect, a single business enterprise, even though conducted by means of more than one corporation. Primarily, the consolidated return was to preclude the reduction of the total tax payable by the business, viewed as a unit, by redistribution of income or capital among the component corporations by means of inter-company transactions.”¹¹

Initially, Congress authorized the IRS to prepare consolidated returns for businesses under common control only where necessary to compute their “correct” tax liability. This was revised in Section 45 of the 1928 Act, which instead gave a very broad power to adjust accounts of related corporations.¹²

Section 45’s language is almost identical to Section 482 of the Code as it read prior to the Tax Reform Act of 1986:

“In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is

¹⁰ “Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to ‘milk’ the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company”, H.R. Rep. No. 350, 67th Cong., 1st Sess. 14 (1921).

¹¹ *Burnet, CIR v. Aluminum Goods Manuf. Corp.*, 287 U.S. 544, 547 (1932).

¹² However, the reference to consolidation was dropped from the anti-avoidance provision (section 240).

necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses.”¹³

Regulations were issued in 1935 which first set forth the fundamental principle of Section 482:

“The purpose of Section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.”¹⁴

However, the regulations provided no other guidance on how to determine an arm’s length price. Congress enacted Section 482 in 1954 (replacing Section 45) without any substantive changes, and it remained substantially unchanged until the Tax Reform Act of 1986 which introduced the “commensurate with income” standard.

Prior to the early 1960s, the small number of U.S. companies with multinational affiliates meant that the statute’s primary application was in domestic cases. For example,

¹³ Revenue Act of 1928, ch. 852, section 45, 45 Stat. 806 (1928).

between 1935 and 1968, out of 168 published cases, only 16 involved international allocations.¹⁵ But in the 1960's, the business climate in which U.S. and foreign multinationals operated had changed substantially, and there was a renewal of concern about the possibilities of tax avoidance offered by transfer price manipulation. This was felt first and most strongly by the United States, as U.S. firms were the most active in expanding abroad. The Treasury Department concluded that Section 482 did not effectively protect the U.S. taxing jurisdiction, and therefore, the U.S. Congress gave strong support for more active enforcement of controls over transfer pricing. The House even approved an amendment to Section 482 which would have allowed formula apportionment of taxable income between affiliates unless the taxpayer could show arm's length transfer prices for tangible property based on comparable market transactions.¹⁶ These proposals were finally omitted from the final bill, as the Finance Committee concluded that Section 482 granted "broad authority to the Secretary of the Treasury or his delegate to allocate income and deductions",¹⁷ i.e. to prevent improper multinational allocations.

In 1968, regulations were issued under Section 482 that divided related-party transactions into five classes, and provided methods and guidelines for determining arm's length prices. The five classes of related-party transactions involved loans and other extensions of credit, the rendition of services, leases of tangible property, licenses or other transfers of intangible property, and sales of tangible property. The methods set forth in the 1968 regulations (the comparable uncontrolled price, the resale price, and the

¹⁴ Art. 45-1(c) of Reg. 86 (1935) (Revenue Act of 1934).

¹⁵ 13 TM-TPR S-3, 4.

¹⁶ SOL PICCIOTTO, INTERNATIONAL BUSINESS TAXATION, A STUDY IN THE INTERNATIONALIZATION OF BUSINESS REGULATION, 187 (1992).

cost-plus methods) had to be applied in that order and provided guidance in establishing arm's length prices or market values for intercompany transactions. A fourth "unspecified method" was authorized when, under the facts and circumstances of a particular case, none of the other three methods could be applied.

Until the Tax Reform Act of 1986, the U.S. transfer pricing system could be interpreted with regard to the comments of the OECD in its reports of 1979 and 1984. However, a survey lead by the IRS showed that the tax authorities had difficulties in obtaining the necessary pricing information from the controlled companies, and especially in valuing intangibles due to the frequent lack of comparable transactions. The classical methods proposed by the OECD then appeared to be unsatisfactory, and a functional analysis was preferred to determine the profits attributable to each company belonging to a multinational group. As part of the Tax Reform Act of 1986, Congress directed the IRS to undertake a study of the operation of transfer pricing mechanisms. The result was the publication in 1988 of a study titled "A study of Intercompany Pricing under Section 482 of the Code"¹⁸, commonly referred to as the "Section 482 White Paper". This reform has been commented upon by numerous detailed temporary and proposed regulations. After lengthy discussion and extensive amendment, new regulations were issued in final form in 1994 through 1996.

SECTION II: OVERVIEW OF THE FRENCH TRANSFER PRICING SYSTEM

While the American authorities were concerned about subsidiaries, especially those formed abroad, some European countries identified the reverse problem: that local

¹⁷ H.R. Rep. 2508, 87th Cong., at 18-19 (1962).

¹⁸ Notice 88-123, 1988-2 C.B. 458.

foreign-owned companies might be “dummies”, transferring their profits to the parent. As it has been pointed out¹⁹, “the most radical approach was taken by the French Treasury, which considered it could impose the tax on income from securities (“impôt sur le revenu des valeurs mobilières”), on the proportion of the dividends distributed by a foreign parent company represented by the value of its holdings in the French branch or subsidiary in relation to its total assets. This concept was resented by foreign investors and their governments as being both extra-territorial and double taxation. The French rejected these arguments, since French companies were also subject to taxation both on their commercial profits and on the dividends paid to their owners. France, however, agreed to mitigate any double taxation by concluding bilateral treaties, which included a provision empowering each state to reallocate any profits or losses transferred between related enterprises due to their relationship being conducted in conditions other than those which would apply between independent enterprises. The French authorities therefore refocused on the “diverted profits” which should be reattributed to the local subsidiary. Hence, a very general provision was enacted in 1933 empowering such diverted profits to be restored to the accounts of the local subsidiary.²⁰

France was one of the very first countries, along with the United States (and also Germany), to introduce transfer-pricing legislation. This legislation, incorporated in Section 57 of the French General Tax Code (*Code Général des Impôts*) remains in almost exactly the same wording as the 1933 provision.

Section 57 of the General Tax Code provides:

¹⁹ SOL PICCIOTTO, *supra* note 15, at 175 (1992).

²⁰ Act of 31 May 1933, art. 76; codified in art.20, Decree of 20 July 1934: Recueil Dalloz Périodique et Critique 1934, p. 172.

“In assessing the income tax due from enterprises which are controlled by or which control enterprises established outside of France, any profits indirectly transferred to the latter, either by an increase or reduction in purchase or sale prices, or by any other means, shall be added back to the trading results shown in the accounts.

The same procedure applies to enterprises which are controlled by an enterprise or a group of enterprises which also control enterprises situated outside France.

The condition of control or dependence is not required when the beneficiary of a transfer is established in a country or a territory with privileged tax status as defined in article 238-A (2) of this Code²¹.

If there is no specific data allowing the reassessment mentioned in Paragraph 1, above, the taxable profits shall be determined according to those earned by similar enterprises carried on under standard rules.”

The U.S. approach is very close, at least in its spirit, to Section 57 of the French General Tax Code. However the implementation of the transfer pricing rules is not similar in both countries, and raises diverse kinds of issues that both countries try to solve.

²¹ added by Finance Act 1982 Art. 90-II.

CHAPTER 2

IMPLEMENTATION OF THE TRANSFER PRICING RULES

As noted above, the authority for making such adjustments is provided by statute (Sections 482 and 57), but also by related income tax regulations and court decisions.

SECTION 1- THE STATUTORY APPROACH

The statutory approach implies 3 different steps:

- The fulfillment of some prerequisites.
- The determination of the appropriate procedure.
- The determination of the scope of the authorities' powers.

A- Requirements under the statutory rules

The three statutory prerequisites for application of Sections 482 and 57 would appear to

be:

- . two or more entities;
- . common ownership or control of such entities; and
- . reported results that do not clearly reflect the income of one or more of the commonly owned businesses.

1- Existence of two or more entities

It follows from Section 57 and Section 482 that at least two entities must be involved in an illicit transfer pricing to be subject to an adjustment.

U.S. rules allow allocations between organizations, trades or businesses, which are owned or controlled directly or indirectly by the same interests. However, the term “organization” is very broad: it includes “an organization of any kind, whether a sole proprietorship, a partnership, a trust, an estate, an association or a corporation, irrespective of the place of organization, operation, or conduct of the trade or business, and regardless of whether it is a domestic or foreign organization, whether it is an exempt organization, whether it is a member of an affiliated group that files a consolidated U.S. income tax return, or a member of an affiliated group that does not file a consolidated U.S. income tax return.”²² Thus where the organization was created does not matter, nor does its nationality. Treasury Regulation § 1.482(i)(2) states that the terms “trade or business” include a “trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place of operation.” The definitional reach of Section 482 is so broad that it covers virtually any conceivable business arrangement between or among any commonly controlled individuals, businesses or types of entity. The potential reach of the provision is extended further by the broad definition of “control” that is applied.

2- Common ownership or control

- U.S. approach

It is important to note that the U.S. statutory rule is stated in terms of parties under “common control” rather than in terms of related parties. Under the US approach, the use of “or” in the phrase “owned or controlled” indicates that it is not necessary to be the legal or economic owner (majority shareholder) of both entities to be subject to Section 482. The control of the latter is sufficient. However, the regulations provide that the term

²² Treas. Reg. 1.482-1(i)(1).

“control” means “any kind of control, whether direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.”²³ The regulations assert further that “it is the reality of the control that is decisive, not its form or the mode of its exercise”, and that “a presumption of control arises if income or deductions have been arbitrarily shifted”²⁴, i.e. when companies shift income or deductions without adhering to the arm’s length requirement. As a consequence, the Tax Court held in *DHL Corp. v. Commissioner* that a corporation was commonly controlled with a second corporation nominally owned by many of the same shareholders even though the real interests of the second corporation were represented by unrelated prospective investors in that corporation.²⁵

The common ownership or control required for the application of Section 482 is not present unless the income distortion sought to be remedied is a result of the ability of one of the parties or its related principal to dictate, through its influence over the management or governance of the other, the terms of the transaction in which the distortion arises.²⁶ If the common control requirement is satisfied, the Commissioner is given broad discretion to adjust results without having to establish tax avoidance.

An important difference between the French and U.S. transfer pricing legislations is that Section 57 applies only when one of the entities involved is foreign. It addresses exclusively transactions arising within an international group. Other cases must be dealt with under the general provisions of the law relating to the deductibility of business

²³ Treas. Reg. § 1.482-1(i)(4).

²⁴ *Id.*

²⁵ T.C. Memo 1998-461, 76 T.C.M. 1122 (7 TM-TPR 664, 1/13/99).

²⁶ See John P. Warner, *Control, Causality, and Section 482*, 7 TM-TPR 289 (1999).

expenses. Unlike the French approach and most anti-avoidance legislations, the U.S. system provides that the same rules apply to transactions between domestic taxpayers as to transactions between residents and non-residents. Thus Section 482 applies even if the companies involved are either both residents in the United States or both non-residents. As a practical matter, however, transfer pricing issues almost never arise between two U.S. corporations, because both are taxable on all of their income on a residence basis. Hence it makes no difference whether income is shifted between them.

- French approach

Section 57 applies to transactions involving:

- a French enterprise and a foreign enterprise that controls it; or
- a French enterprise and a foreign enterprise that it controls; or
- a French enterprise and one or more foreign enterprises that are controlled by the same enterprise, group, or consortium.

The French tax authorities interpret the notion of control to include both legal control and “de facto” control.²⁷ Indeed, one of the essential tests –which the tax authorities should establish– is that one of the enterprises involved in the transfer of profits is legally or “de facto” under the control of the party granting or benefiting from a transfer.

There is deemed to be legal control when the foreign company holds a majority of the capital or shareholder votes of the French company, or where the foreign company (directly or through intermediaries) exercises functions in the French company carrying the power to make decisions.

An intermediary person can be:

²⁷ D.adm. 4A 1211, no 4, September 1 1993.

- a manager, director, executive of the controlling enterprises and members of their family;
- any enterprise which is directly or indirectly controlled by the managing company;
- any person who has an interest in the commerce or industry of any of those enterprises or a part of their capital.²⁸

In particular, the dependence test is deemed to be satisfied with respect to a parent company and its French subsidiaries and with respect to a French parent company and its foreign subsidiaries. However, even if legal control cannot be shown to exist, there can be “de facto” control; based upon the particular facts and circumstances of the case. This may be contractual in origin or may flow from the business relationships between the 2 companies. The concept of “de facto dependence” is not entirely clear since the Regulations merely stress that in situations where legal dependence cannot be demonstrated, Section 57 may still be applicable if there is a de facto dependence or a control in fact, without much explanation. From the case law, it appears that a de facto dependence can generally be found where the enterprises have interlocking contractual, financial, or supply arrangements that permit one company to control the other.²⁹

Control was found to exist, for example, in a case involving a Danish group controlling 98% of a French company, and whose principal manager was also a member of the French company’s board of directors.³⁰

The dependence test is under the strict control of the courts. The case law is very clear in holding that Section 57 may not be applicable if the tax authorities are not able to

²⁸ *Id.*

²⁹ Bruno Gouthière, *Transfer Pricing Legislation Amended: More Control Expected*, International Bureau of Fiscal Documentation, European Taxation, Volume 36. No 7 (1996).

³⁰ CE, 25 January 1989, no 49847, RJF 3/89.

sufficiently prove the legal or de facto dependence. This situation depends exclusively on the facts and circumstances of each particular case.

3- Existence of a transfer of profits

According to Section 57 of the General Tax Code, the tax administration is empowered to adjust prices between related companies only if it can be shown:

- that a French enterprise is controlled by a foreign enterprise, or controls it; and also
- that profits have actually been transferred abroad.

The scope of Section 57 is very broad. It can be triggered by all kinds of transfers of profits, either by an increase in purchase prices or a decrease in sales prices, or by any other means. It may apply to the payment of excessive interest, royalties, management fees, or the granting of interest-free loans, and waivers of claims.

The third prerequisite under Section 482 of the Internal Revenue Code would appear to be reported gross income, deductions, or credits that reflected tax avoidance, or at least, reported results that did not clearly reflect the income of one or more of the commonly owned organizations, trades or businesses. Even though recent developments and new interest in the non-transfer pricing aspects of the statute have occurred, in the past 20 years or so, Section 482 litigation, regulations, and literature have focused on the third requirement, particularly on the evolution of the arm's length standard for transfer pricing among commonly owned or controlled entities.

B- Appropriate procedure

Under the French approach, the tax authorities bear the burden of proving that the transaction they intend to adjust does not reflect what would occur between two unrelated enterprises. This requirement will be met if the administration shows that an undue advantage has been granted, like, for example, excessive increase or decrease in purchase or sale prices, payment of fees that are either excessive or for no real consideration, and granting of loans which are interest-free or at a reduced price. The evidence may be based on the information which the tax authorities have in their files, the documentation which they have gathered from their investigations in the company, and generally all facts and circumstances of which they are aware. Establishing the existence of such a benefit amounts to prima facie evidence that a transfer of profits has been achieved. For example, proof that the sale price is too low or that the purchase price is too high constitutes prima facie evidence of a transfer of profits. Indeed, Section 57 of the General Tax Code establishes a presumption of transfer of profits.

In this respect, the administration is not required to demonstrate that the parties intended to transfer profits. The showing of an undue advantage is sufficient to establish a presumption of abnormality regarding the transaction. But this presumption is rebuttable, and the taxpayer may seek to avoid an adjustment by showing either that the undue benefit does not exist, or that prices were not established to avoid taxes, but reflect actual business needs.

However, it must be noted that when transactions are carried out with enterprises or individuals located in tax havens, it is not necessary for the tax authorities to establish

the existence of control in either direction between payor and payee.³¹ Indeed, Section 57 *in fine* provides that “tax authorities are allowed to presume control when an advantage is accorded to an enterprise located in a low tax country as defined for Article 238A purposes”. A country will be considered to be a tax haven if no tax rate applies, or if the rate is at least one third less than the French corporate tax rate.³²

It is nevertheless important to note that even in that case, the tax authorities have to provide proof that the foreign enterprise really enjoys a privileged tax regime.

Under the U.S. system, the authority of the IRS to make adjustments does not necessarily depend on any tax-motivated behavior by the taxpayers involved. It arises not only in the case of “evasion”, but also in any circumstances in which adjustments are necessary clearly to reflect income. As a practical matter, of course, the discovery by IRS agents of the evidence that pricing arrangements were established purposefully to avoid U.S. taxes is likely to increase the probability of an adjustment under Section 482.³³ A taxpayer seeking to challenge the adjustment bears the burden of proving that it is “arbitrary, capricious or unreasonable.”³⁴ This rule was created by the courts and is not mentioned in the regulations. It has also been severely criticized. Indeed, successfully demonstrating that the IRS analysis is inappropriate or inaccurate will not suffice. In a well-known decision³⁵, for example, the U.S. Court of Claims sustained the proposed IRS adjustment, stating that they “focus on the reasonableness of the result, not the details of the examining agent’s methodology”. The Tax Court even concluded in a 1993 case³⁶ that the taxpayer had met the burden of showing that the IRS allocations to be “arbitrary,

³¹ Section 57 *in fine* of the French General Tax Code (2000).

³² Section 238A of the French General Tax Code (2000).

³³ See CHARLES GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS, 503 (1997).

³⁴ American Terrazzo Strip Co. v. Commissioner, 56 T.C. 961 (1971).

capricious, or unreasonable”, but it noted further, however, that such a finding “does not relieve the taxpayer of its burden of proving that the transactions meet the arm’s length standard”.

C- Powers of the competent authority

Section 57 of the General Tax Code restores trading profits to those that would have been achieved under arm’s length transactions. Indeed, if inter-company pricing adjustments are made, then not only would the amount of the adjustment be restored in the tax computation of the French company, but it may also be considered a constructive dividend distribution. This is because Section 109 of the General Tax Code (GTC) provides that all profits which are not entered into a reserve or capitalized are deemed to be distributed as income which are subject to a withholding tax, if the recipient is residing abroad, at the rate of 25% as provided for in Section 187 GTC. Thus, if the recipient is resident in a country without a double tax treaty with France, such pricing adjustments will have a dramatic tax effect.

Where the recipient, however, is resident in a country which has a tax convention with France, the dividend article contains a definition of dividends which overrides domestic law, and which does not cover deemed income distributions under Section 109 GTC. In such cases, the deemed income distributions fall under the “other income” article if relevant, which would normally provide that such items of income are taxable only in the country where the recipient is a resident, thereby precluding the French tax

³⁵ E.I. DuPont de Nemours & Co. v. United States, 608 F.2d 445, 454-55 (Ct.Cl. 1979).

³⁶ Pekin-Elmer Corp. v. Commissioner, 66 T.C.M. (CCH) 634 (1993).

administration from imposing a withholding tax on such deemed constructive dividends.³⁷

The scope of Section 482 is so broad that we can say that the IRS has a discretionary power to adjust income of related companies. The good faith of the taxpayer or the absence of tax-avoidance motivation will not themselves be a defense to an adjustment under Section 482.³⁸ The US income tax authorities' power is very broad: they may distribute, apportion or allocate gross income, deductions, credits or allowances between parties under common control.³⁹

The standard stated both in the French and in the U.S. legislations for evaluating such transactions is the arm's length standard. This is the income that would have resulted if an uncontrolled taxpayer were dealing with another uncontrolled taxpayer. The regulations explain that the purpose of the provision is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining the true taxable income of the controlled taxpayer.⁴⁰ The arm's length standard requires reference to comparable transactions and relevant data. The reference will be the results of comparable transactions under comparable circumstances.

Multinational corporations anticipate increased audits as tax authorities intensify their scrutiny of transfer pricing, according to a survey of corporate tax and finance directors released in 1999 by Ernst & Young LLP.⁴¹ The survey polled international tax

³⁷ Roy Saunders, *Transfer Pricing and the Multinational Enterprise*, International Bureau of Fiscal documentation, Volume 29, No. 8 (1989).

³⁸ Treas. Reg. § 1.482-1(c)

³⁹ 26 USC 482 (1999).

⁴⁰ Treas.Reg. § 1.482- 1(a)(1)

⁴¹ *Enforcement: More Transfer Pricing Audits Expected as Authorities Intensify Scrutiny*, 14 TM-TPR 627 (1999).

directors at 582 multinational parent companies in 19 countries, and 124 foreign-owned subsidiaries in Europe and North America.

Seventy-four percent of European companies said they believed they would face a transfer-pricing audit in the next two years, compared with Canada (64%), the United States (62%) and Mexico (21%). Companies headquartered in the Netherlands hold the record for being the most audited, the survey reported. Eighty-four percent of the Dutch companies said they have been examined for transfer pricing. The Dutch were followed by Canada (80%), Germany (79%), **France (78%)**, Australia (76%), Switzerland (71%), the United Kingdom (71%), and **the United States (70%)**.

With the exception of Canada and Australia, where the examination rates were higher at home than away from home, the companies in those countries reported the highest examination rates because of transfer-pricing audits held outside their home countries. For example, only 30 percent of the French companies surveyed reported having a transfer-pricing audit in France, but 70% reported that they have been examined outside France.

Multinationals also said it is becoming commonplace for their transfer pricing practices to be audited by more than one tax authority. Seventy-six percent of Canadian companies reported a Revenue Canada investigation, while 64% of the companies reported being audited by the U.S. Internal Revenue Service. The exception to this trend was Japan, where 48% of the respondents in that tax country reported being audited by the United States, but not by their own tax authority, the survey added.

Antoine Glaize, head of the International Division for Tax Audit of the French Ministry of Economics, said the French government made:

- 100 transfer pricing adjustments in 1994,
- 79 adjustments in 1995,
- 114 in 1996,
- 206 in 1997, and
- 352 in 1998.⁴²

“The tax authority’s increase in activity (transfer pricing adjustments increased by 250 percent over four years) came in response to aggressive audit practices abroad”⁴³, according to Mr. Glaize. France “felt it was too soft in comparison with other countries”⁴⁴—such as the United States and Japan— Glaize added. He also reported that the French government has assessed 18 penalties in transfer pricing cases. However, he stated, the penalties were not actually applied in any of the cases. Penalties are not widely used in France and are meant to have a dissuasive effect.

Litigation: Amount of disputed allocations in the United States

Pending Litigation: 1999

Twenty-seven new transfer pricing cases challenging \$838.5 million in Section 482 allocations were filed in the first half of 1999. At the same time, 24 cases with Section 482 issues were resolved by June 30, 1999, eliminating disputed allocations of \$120.9 million. Thus, total transfer pricing allocations at issue in federal courts rose to \$2.4 billion by July 1, 1999. Most of the new allocations can be attributed to two cases filed by United Parcel Service of America Inc. The Atlanta-based delivery company challenged \$650.1 million in Section 482 adjustments for 1985-90. In both cases, the

⁴² *France: Transfer Pricing Adjustments Increased by 250 percent Over Four Years, Official says*, 16 TM-TPR 681 (1999).

⁴³ *Id.*

⁴⁴ *Id.*

Internal Revenue Service reallocated income to UPS from Overseas Partners Ltd. (OPL), the Bermuda company created in 1983 to handle its package insurance. The Service argued that OPL was a sham formed for the purpose of shifting UPS' income offshore, while UPS contended it created the subsidiary to avoid risk and also out of concern that its prior insurance arrangement violated state regulations.⁴⁵

Pending litigation: 2000

The amount of transfer pricing allocations at issue in federal courts remained steady at about \$4 billion over the first half of 2000. Fourteen cases contesting a total of \$242.1 million in Section 482 allocations were filed between January 1 and June 30 of 2000, while at the same time, 30 cases that together had challenged \$242.2 million in transfer pricing adjustments were resolved.⁴⁶

SECTION II- THE REGULATORY APPROACH OR HOW TO CONTROL AND DETERMINE TRANSFER PRICING.

Most countries, including France, have not written specific rules to apply the arm's length principle to particular transactions but rather apply a broad, generally worded rule to a vast array of transactions. Exceptions are the United States and, more recently, Germany. The United States was the first to codify its rules in this area and in some detail. The specific rules in the U.S. and Germany appear to cover most of the more common types of transactions, whereas a few other countries have written protective rules to cover specific areas where they feel they are exposed.

⁴⁵ *Litigation: Section 482 Allocation Challenges Rose to \$2.4 Billion in Year's First Half*, 7 TM-TPR 270 (1999).

⁴⁶ *Litigation: Amount of Disputed Allocations Unchanged From Close of 1999 as Cases Resolved, Filed*, 6 TM-TPR 164 (2000).

Belgium, France and Japan make specific alterations to the rules when there are payments to tax haven countries.⁴⁷

Under the U.S. approach, the general rule is that U.S. income tax authorities may distribute, apportion or allocate gross income, deductions, credits or allowances between parties under common control where it is necessary to prevent evasion of taxes or to reflect clearly income.

The regulations provide specific rules for five types of transactions as follows:

- interest rates on loans or advances,
- prices for performance of services,
- rentals for use of tangible property,
- prices for transfer or use of intangible property,
- prices for sales of tangible property.

A- Approaches to Arm's Length Pricing

1- Sales of tangible property

- French approach

As mentioned earlier, a transfer of profits can occur through the increase of purchase prices or the decrease of sale prices. To determine if such a transfer actually took place and in order to make necessary adjustments, the administration may use various methods.⁴⁸ The corrections should normally be made based on the specific data relating to the transaction at issue. When specific data is insufficient to readjust the profits subject

⁴⁷ See Sections 57 *in fine* and 238A for the French transfer pricing system.

⁴⁸ Section 57 of the General Tax Code (2000).

to French tax, the correction may be achieved by means of comparison with profits generated by similar businesses or through similar transactions.

Section 57 generally requires that transfer-pricing transactions with foreign related parties (or even unrelated parties if situated in a tax haven) be at arm's length. For these purposes, two types of comparison can be made.

The first method consists of determining whether the company involved deals with unrelated parties on the same terms and conditions as it deals with unrelated parties. The French tax administration looks at the price that would have resulted if the foreign company were dealing with an uncontrolled taxpayer. Thus the comparable uncontrolled price method is prescribed.

According to the second method, the amount of taxable income may be determined by comparing it with the taxable income of similarly operated companies.⁴⁹ Indeed, Section 57 further authorizes the tax authorities to use a comparable profit method where no precise pricing guidelines are available.

It is also important to note that the key word in the French provision is “reasonableness” rather than arm’s length. Any “abnormal” decision of management may also be subject to review.

Specific example

Assumed facts

Assume P (the French parent company) is a manufacturer that sells finished products to its subsidiary S, which is located in a different country. P sells these products to S at cost. P also sells these products to unrelated parties at cost plus a 10 percent mark-up. Both S

and the unrelated parties incur the same selling and promotional expense, and both resell P's products at the same price per unit.

Consequences to P

- 1- Income may be allocated to P by French tax authorities.
- 2- In the note of May 4, 1973, the tax authorities indicated that the tax inspectors should refer to the prices at which the foreign manufacturer generally sells products to independent companies in evaluating the price charged to French affiliates for these same products. The same rule applies for pricing of goods sold by a French company to foreign affiliates. Consequently, in this specific example, the 10 per cent mark-up would probably be allocated to P.
- 3- In theory, even if there were no sales to independent parties, the tax authorities would not accept zero profit margins on sales to the subsidiary company since unrelated parties normally sell products at a profit.

However, the tax authorities would have to prove the basis for the adjustment. When comparable uncontrolled prices do not exist, experience shows that the methods most commonly considered are the cost-plus and resale price methods. But if the foreign subsidiary were undertaking a greater amount of selling and promotional expenses, most companies would take this into account in deciding what arm's length prices really were. Many countries would be inclined to take a look at the gross or net income being realized by the foreign subsidiary in an attempt to determine whether that was a fair return for the work being performed by that subsidiary.

⁴⁹ Regulation 4J-2-91 of 2 July 1991.

Many countries would also allow the transfer price to a foreign subsidiary to be lowered (in some cases even below cost) to establish or protect a market in the foreign country.

Some countries, like the United States and Canada, would lower these prices only if it could be demonstrated that the local parent company would act in the same way when dealing with an unrelated party. Other countries would allow the local parent company to lower the transfer prices so as to establish their own foreign subsidiary in a foreign market. There does not appear to be consistent applications of the rules in this area.

Under the French approach, in the Note of May 4, 1973, tax inspectors are encouraged not to apply Section 57 in respect of sales which, for commercial reasons (e.g. to establish a market), have been made to subsidiaries at prices near to cost. Furthermore, the Supreme Administrative Court (Conseil d'Etat) has decided that the parent company may charge preferential prices to a subsidiary which has some difficulty in carrying on the business.⁵⁰

- U.S. approach

Assumed facts

Assume similar facts.

P is the parent company and a manufacturer that sells finished products to its subsidiary S, which is located in a different country. P sells these products to S at cost. P also sells these products to unrelated parties at cost plus 10 per cent mark-up. Both S and the

⁵⁰ CE, 2 June 1982, no 23 342, RJF 7/82, p328.

unrelated parties incur the same selling and promotional expense and both resell P's products at the same price per unit.

Consequences to P

- 1- Income may be allocated to P by U.S. tax authorities.
- 2- The U.S. tax authorities will determine an appropriate price and assert that P's taxable income should be increased by the difference between the appropriate price and the price actually paid. The standard for an appropriate price for sales of tangible property is an arm's length price, defined in the regulations as the price which an unrelated party would have paid under the same circumstances for the property involved in the sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.
- 3- The previous regulations provided guidance for determining the arm's length price for various types of transactions. They prescribed the following techniques for applying arm's length standards in respect of sales of tangible property:

- Comparable Uncontrolled Price Method (CUP)

The best determination of an arm's length price is the price in a comparable uncontrolled transaction. The basic approach is to examine comparable sales where the parties are unrelated, i.e. where two parties are not under common control. These may include sales by a member of the controlled group to an unrelated party, sales by an unrelated party to a member of the controlled group, and sales made in which neither party is a member of the controlled group.

In order to be used to establish a comparable uncontrolled price, such a sale would need to involve identical property and circumstances to that for which a

price is being determined, or so nearly identical as to allow a reasonable number of adjustments of price to reflect the differences. Differences which might affect the price or make sales non-comparable include quality of product, terms of sale, intangibles (such as trade names) associated with the sale, time of sale, level of distribution and the geographic market in which the sale is made.

- Resale Price Method

The regulations state that a typical situation where the resale price may be useful is one “involving the purchase and resale of tangible property in which the reseller has not added significant value to the tangible goods by physically altering the goods”⁵¹ or through use of an intangible. A typical situation in which this might apply is where a manufacturer sells products to a related distributor (reseller) for resale, without further processing, to purchasers which are not under common control with P and S.

Under this approach, the price for the controlled transaction is equal to the resale price to an uncontrolled taxpayer less an “appropriate gross profit”. The appropriate gross profit is determined by multiplying the applicable resale price by the “gross profit margin” (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions.⁵²

The approach is to determine an appropriate mark-up percentage based upon sales by resellers in which both the purchase is from and the resale is to parties not under common control. The anticipated resale price of the property is discounted

⁵¹ Treas. Reg. § 1.482-3(c)(1).

⁵² Treas. Reg. § 1.482-3(c)(2)(iii).

by the appropriate mark-up percentage to determine the price to the reseller. For this method to apply, the resale price must be available. Also, the reseller should not add more than an insubstantial amount to the product.

- Cost Plus Method

Under this approach, the transfer price is generally equal to the cost of production plus an amount determined by the application of a “gross profit markup” to that cost. The gross profit markup is “expressed as a percentage of cost, earned in comparable uncontrolled transactions.”⁵³ The regulations state that “the cost plus method is ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.”⁵⁴ A typical situation in which this might apply is where a manufacturer sells products to a related entity which either performs substantial processing or adds substantial value to the product before resale to purchasers which are not under common control with P and S.

- Other appropriate methods

If none of the three methods above apply, then the taxpayer might use some other appropriate method. Settlement of disputes with income tax authorities was often negotiated on the basis of such another appropriate method.

The alternative methods were prescribed in order of preference. If the most preferred method could not be applied, the next was invoked. If any of the methods mentioned

⁵³ Treas. Reg. § 1.482-3(d)(2)(ii).

⁵⁴ Treas. Reg. § 1.482-3(d)(1).

above could apply, then another appropriate method had to be invoked. Thus the resale price method could apply only when there was no comparable uncontrolled price, and the cost-plus method applied only when the previous two methods did not apply.

These approaches are still prescribed by the current regulations. However, under “the best method rule”⁵⁵, they are no longer presented in order of preference: the method providing the most reliable arm’s length price must be used. There is no strict priority of methods, and no method will invariably be considered to be more reliable than others.

The current regulations describe five methods for judging the acceptability of a transfer price for the resale of tangible personal property, along with a sixth category called “unspecified methods.”⁵⁶ They include the three methods authorized by prior regulations: the comparable uncontrolled price, resale price and cost-plus methods, augmented by the comparable profits⁵⁷ and the profit split methods.⁵⁸

- Comparable Profits Method (referred to as CPM)

The CPM determines the arm's length consideration for a controlled transfer of property by referring to objective measures of profitability called “profit level indicators” derived from uncontrolled taxpayers engaged in similar business activities with other uncontrolled taxpayers under similar circumstances. The related party, whose operating profit is tested, is referred to as the “tested party”. The tested party need not, however, be the taxpayer, but may instead be another member of the controlled taxpayer’s group, such as its parent corporation.⁵⁹

- Profit Split Method

⁵⁵ Treas.Reg. § 1.482-1(c)(1).

⁵⁶ Treas.Reg. § 1.482-3(a)(1).

⁵⁷ Treas. Reg. § 1.482-3(a)(4).

⁵⁸ Treas. Reg. § 1.482-3(a)(5).

The Profit Split Method is intended to determine transfer prices for specific transactions rather than to apportion the total income of a “unitary business” among related parties.⁶⁰ The operating profit or loss is determined from the most narrowly identifiable business activity of the controlled taxpayer which includes the controlled transaction.⁶¹ Such profit or loss is then divided between the controlled parties based upon “the relative value of each controlled taxpayer’s contributions” to the success of the activity. The value of each party’s contributions is to be based upon “the functions performed, risks assumed and resources employed.”⁶²

The division can be accomplished in one of two ways: the comparable profit split or the residual profit split.⁶³

- Unspecified method

In addition to the previously mentioned methods, another “unspecified method” may be used,⁶⁴ subject to compliance with the general principles and guidelines set in the Regulations.

As a result, the new regulations provide several specific methods which may be used in various circumstances to test the arm's length nature of a taxpayer’s pricing structure. However, all these specific methods are subject to general rules on comparability which appear in Section § 1.482-1(d) of the regulations. The arm's length character of a controlled transaction usually is analyzed “by comparing the results of that transaction to

⁵⁹ Treas. Reg. § 1.482-5(a) and (b)(1) and (2).

⁶⁰ JOHN E. MCDERMOTT, JR. AND ALL, *TRANSFER PRICING UNDER U.S. LAW-THE NEW REGIME*: 1994 FINAL REGULATIONS, 51, 1995.

⁶¹ Treas. Reg. § 1.482-6(a).

⁶² Treas. Reg. § 1.482-6(b).

⁶³ Treas. Reg. § 1.482-6(c)(1). For more details about the comparable profit split method and the residual profit split method, see JOHN MCDERMOTT, *supra* note 44 at 52-4.

results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.”⁶⁵ The regulations state that an uncontrolled transaction does not necessarily need to be "identical" to a controlled transaction in order to be comparable. Instead, all that is required is that the transactions be sufficiently similar so that the uncontrolled transaction provides a reliable measure of an arm's length result.

The new regulations identify a number of factors to take into consideration to determine the more appropriate method. The five comparability factors are discussed below:

- Functions

Under a functional analysis, it is necessary to identify and compare the economic functions carried out by the parties involved in the controlled and uncontrolled transactions, and the resources employed in this regard, including the types of assets. The regulations provide a list of functions that must be considered to determine the comparability of the controlled and uncontrolled transactions:

- a- Research and development;
- b- Product design and engineering;
- c- Manufacturing, production and process engineering;
- d- Product fabrication, extraction and assembly;
- e- Purchasing and materials management;
- f- Marketing and distribution functions, including inventory management, warranty administration and advertising activities;
- g- Transportation and warehousing; and

⁶⁴ Treas. Reg. § 1.482 (3)(e)(1).

⁶⁵ Treas. Reg. § 1.482-1(d)(1).

h- Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.⁶⁶

- Contractual terms

Relevant terms that could affect the results of the two transactions include:

- a- the form of the consideration charged or paid;
- b- the volume of products purchased or sold;
- c- the scope and terms of warranty obligations;
- d- the duration of the contracts and related termination or renegotiation rights;
- e- the payment terms or extension of credit.

- Risks

Another important factor to be considered in judging the comparability of controlled and uncontrolled transactions concerns the significant risks assumed by the parties to the transactions. It is indeed necessary to evaluate risks that could affect the pricing or the profitability of the transactions.

Again, the regulations provide a list of items involved in risk analysis:

- a- Market risks, including fluctuations in cost, demand, pricing, and inventory levels;
- b- risks associated with the success or failure of research and development activities;
- c- financial risks, including fluctuation in foreign currency rates of exchange and interest rates;
- d- general business risks related to the ownership of property, plants and equipment.⁶⁷

⁶⁶ Treas. Reg. § 1.482-1(d)(3)(i).

- Economic conditions:

The significant economic conditions affecting the controlled and uncontrolled transaction must be compared on the basis of their ability to affect the prices paid or profits earned. The controlled and uncontrolled transactions should be compared as to the relevant market shares, their similarity in size and the composition of geographic markets, the extent of competition...

- Nature of property or services

The regulations also require a comparison of the property or services transferred in the controlled and uncontrolled transactions to determine their comparability.

- 1- If sales to uncontrolled parties are comparable to the sales to the foreign subsidiary S (e.g. same volume, level of distribution), then the price may be a comparable uncontrolled price and should be used for the sale from P to S.
- 2- If there were no sales to uncontrolled parties or if the sales to uncontrolled parties were not similar enough to be comparable uncontrolled sales, then the comparable uncontrolled price method would not apply, and one of the other pricing methods would apply. The resale price method probably applies most commonly in situations similar to the example.
- 3- If S incurs greater expense, the price to S may be affected, depending on the method used to establish prices on sales to S as follows:

- i- Comparable uncontrolled price method

The price to S would be unaffected. Different promotional and selling expenses, however, might indicate that the sales are not really comparable.

⁶⁷ Treas. Reg. § 1.482-1(d)(3)(iii)(A).

ii- Resale price method

The price to S would normally be unaffected because the costs used to calculate the mark-up percentages normally would not include promotional and selling expenses.

iii- Cost-plus method

The price to S would be reduced to allow S a greater profit on its greater costs.

- 4- The regulations allow pricing at a reduced profit or even at a loss to establish or maintain a market for a seller's products. However, this is allowed only in situations where P would have priced similarly in sales to uncontrolled purchasers. Greater promotional and selling expenses incurred by S might be evidence that P is pricing to maintain or establish a market.

2- Interest

The same criteria apply in every kind of transaction. An illicit transfer of profits would occur, for example, if a parent corporation loans money to its foreign subsidiary with no interest rate or with a very low rate.

Under the French approach, the 1973 note provides that where a loan is made to a foreign related company without interest or at a reduced rate of interest, grounds exist for including in income an amount to reflect a normal charge. However, several court decisions have stated that an interest-free loan made to a financially troubled subsidiary was not subject to Section 57 because the French parent was protecting its ownership.⁶⁸ If

⁶⁸ CE, 2 June 1982, no 23 342, RJF 7/82, p.328; similar decision about rentals: CAA Paris, 18 March 1993, no 92-34, 3e ch., Min. c/ Ste Sofiltra-Poelmann, droit fiscal 1994, no 5, comm.no 165.

no income is imputed to the French parent, the related interest expense of the French parent is not denied as a deduction.

Under the U.S. approach, a similar result would be reached, and interest would likely be allocated to P.

3- Rentals for use of tangible property

Assume the following facts:

P is a multinational company whose main business is manufacturing and selling. P plans to establish a foreign sales subsidiary S located in country S. Land and a warehouse which P owns in country S will be used as a site for S's operations. P plans to make this land and warehouse available to S at a fee of \$1 per year for 99 years.

- French tax authorities would allocate income to P for the use of the property at arm's length rate and rental.

- A similar solution would apply under the U.S. approach. An arm's length rental charge would require a comparison of rental arrangements with independent parties under similar circumstances considering:

- the period and location of the use;
- the owner's investment in the property or the rent paid for the property;
- the expenses of maintaining the property;
- the type of property involved and its condition;
- and all other relevant facts.⁶⁹

4- Provision of services

P is a large multinational company which wholly owns foreign subsidiary S. Both P and S are engaged in manufacturing and sales activities. P's headquarters division performs general management services for P's multinational operations, including services which directly relate to S. The services performed for S include periodic visits by P's executives to review S's operations, financial analysis of S's future requirements, engineering services in connection with S's manufacturing activities, and marketing services in connection with S's sales activities. P does not charge S for such services.

Theoretically, under the French approach, an imputed charge could be included in P's taxable income. Such an adjustment, however, is unlikely for general management, periodic reviews and financial analysis.

The U.S. regulations provide that "where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge," appropriate allocations may be made to reflect an arm's length charge for such services.⁷⁰

An arm's length charge for services would be "the amount charged for similar services in independent transactions between unrelated parties under similar circumstances considering all relevant facts."⁷¹

B- Exploitation of Intangible Property

⁶⁹ Treas.Reg. § 1.482-2(c)(2).

⁷⁰ Treas.Reg. § 1.482-2(b)(1).

⁷¹ Treas.Reg. § 1.482-2(b)(3).

The category of intangibles covers a very broad range of assets, related both to production and to marketing, such as patents, copyrights, designs and trademarks, and business know-how. Intangibles are particularly important to multinationals, as their preeminence is often due to technological advances.

Assume that P and S are manufacturers located in different countries. P performs research and development in France, which has led to its ownership of certain intangibles consisting of patents, trademarks and know-how. P makes available to S the exclusive right to use in S's country all of P's intangibles. P does not charge S for the use of P's intangibles.

The rule under the French legal system for intangibles remains the same. Income will be allocated to P. The allocation will be in the form of annual royalties and will be computed on an arm's length basis.

Unlike the French approach, the U.S. transfer pricing system offers a different view for intangible property, especially since the Tax Reform Act of 1986. The current regulations state that the arm's length amount charged in a controlled transfer of intangible property must be determined under one of the four following methods:⁷²

- the comparable uncontrolled transaction method;
- the comparable profits method;
- the profit split method; and
- unspecified methods.

Although each of the methods must be applied in accordance with the best method rule, the comparability analysis and the arm's length range, it is important to note that the arm's

⁷² Treas.Reg. § 1.482- 4(a).

length consideration⁷³ for the transfer of an intangible must be commensurate with the income attributable to the intangible.⁷⁴

The White Paper articulated the implications of the “commensurate with income” requirement inserted by Congress into Section 482, while arguing that it is compatible with the arm's length standard.

1- The former approach

The 1993 regulations provided that transfers to unrelated parties of the “same or similar intangible property under the same or similar circumstances” should be the best indication of arm's length consideration.⁷⁵ Recognizing the particular difficulties of finding comparable transactions, if no “sufficiently similar transaction” was available, the regulations listed 12 factors to be considered in determining the arm's length consideration. These factors included the prevailing rates in the same industry, offers of competing transferors or transferees, the terms of the transfer (including limitations on use), the capital investment and start-up expenses of the transferee, the prospective profits to be realized by the transferee, and the transferor’s costs in developing the property.⁷⁶

The most popular method that was developed by the courts was the profit split method. Under this method, the operating profit or loss was divided between the controlled parties based upon the value of each controlled taxpayer’s contributions to the success of the activity (based upon the functions performed, risks assumed and resources employed). As the relatively long list of appropriate factors did not necessarily facilitate the work of

⁷³ Arm's length consideration is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances.

⁷⁴ Treas.Reg. § 1.482- 4(a).

⁷⁵ Treas.Reg. § 1.482- 2A(d)(2)(ii) (1993).

⁷⁶ Treas.Reg. § 1.482- 2A(d)(2)(iii) (1993).

judges called upon to resolve disputes between the IRS and the taxpayers, the current regulations provide for the use of four possible methods, as mentioned above.

2- Tax Reform Act of 1986

The IRS was aware of the possibility of avoiding taxes through the exploitation by foreign affiliates of technology developed in the United States. As a result, by the Tax Reform Act of 1986,⁷⁷ Congress amended Section 482 –the first substantial amendment of that section since 1928– as follows:

“In the case of any transfer (or license) of intangible property, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible”.

This provision is known as the “Super-Royalty” provision. The royalty paid by the transferee of intangible property rights to its commonly controlled owner is subject to a periodic review and adjustment by the IRS that reflects the actual profit experience of the parties in a transfer of intangibles. The purpose is to ensure that the consideration paid over time remains commensurate with the income produced by the intangible in the hands of the transferee. The White Paper defends this as compatible with the arm's length standard, citing evidence that unrelated parties also renegotiate terms, either on the basis of explicit clauses providing for renegotiation or by using termination clauses to do so.

3- Cost Sharing Arrangements

A cost sharing arrangement is an agreement between 2 or more persons to share the costs and risks of research and development as they are incurred in exchange for a specified interest in any intangible property that is developed.

⁷⁷ Pub.L.No 99-514, 100 Stat. 2095 (1986).

It is provided as a basic alternative to arm's length royalty arrangements between related parties with respect to intangibles.

Treasury regulation § 1.482-7(b) provides that “a qualified cost sharing arrangement must:

- 1- include two or more participants;
- 2- provide a method to calculate each controlled participant's share of intangible development costs, based on factors that can reasonably be expected to reflect that participant's share of anticipated benefits;
- 3- provide for adjustment to the controlled participants' shares of intangible development costs to amount for changes in economic conditions, the business operations and practices of the participants, and the ongoing development of intangibles under the arrangement; and
- 4- be recorded in a document that is contemporaneous with the formation (and any revision) of the cost sharing arrangement”.

A cost sharing arrangement should reflect a reasonable effort to share the costs of developing intangibles in proportion to the benefits that each eligible participant anticipates it will receive from the exploitation of the intangibles.

Thus no royalties are paid by the participants for exploiting their rights to such intangibles, and there is no need to fix an arm's length price.

CHAPTER 3
ISSUES RAISED BY THE IMPLEMENTATION OF BOTH LEGISLATIONS AND
SOME POTENTIAL SOLUTIONS

One of the most difficult problems facing multinational businesses is the prospect of double taxation. Double taxation generally occurs in the context of transfer pricing adjustments, where the tax authorities in competing jurisdictions disagree over income allocations attributable to transfer pricing. Consequently, two or more countries may claim jurisdiction to tax the same income. The affiliated group therefore may suffer tax liability in two different tax jurisdictions. However, tax treaties signed by France and the United States generally follow the 1992 OECD Model Convention that prevents such double taxation. Also based on the idea that the tax authorities must have sufficient information to make satisfactory transfer pricing cases, and on the experience that “the majority of taxpayers do not provide an explanation of how their intercompany pricing was established”⁷⁸, both the French and the U.S. tax authorities have introduced new procedures that increase the documentation requirements.

⁷⁸ See *59 Fed. Reg. 4791 (1994)* (comments to temporary regulations).

SECTION I- DIFFICULTIES TAXPAYERS MAY FACE

A- Economic Double Taxation

First of all, it is necessary to distinguish between legal double taxation and economic double taxation.

- Legal Double Taxation

The legal double taxation implies a situation in which a single taxpayer is taxed on the same income by more than one country.

Assume that X, a French resident, owns land in country Y that will be used as a site for Z's operations. Z is a resident of country Y. Income will be allocated to X in France because according to the French tax system, a French resident is taxed on his worldwide income, and X will also be taxed in country Y, assuming that the source of rental income in country Y is determined by the place where the property is located.

- Economic Double Taxation

The OECD defines economic double taxation as the situation in which two distinct entities are taxable on the same income by two countries.

Assume that a U.S. corporation, X, sells goods to a French subsidiary, Y, for \$100 per unit. Then the French tax administration, asserting its authority under Section 57, estimates that the price \$100 per unit is too high, and that the correct price, according to arm's length standards, should be \$50 per unit.

As a consequence, there is a transfer of profits from France to the United States.

The adjustment in France gives rise to economic double taxation, as the remaining \$50:

- is not included in the allowed deductible business expenses in France –this means that the company will be taxed on it, as it will be considered as a distribution of profits– and
- is taxable in the U.S., according to U.S. tax rules.

Thus a double taxation occurs with regard of the excessive amount of royalties; the double taxation is economic, as it results from the taxation of two distinct taxpayers, the French subsidiary and the U.S. corporation, in two different countries, France and the United States.

Double taxation generally occurs in the context of transfer pricing adjustments, where tax authorities in competing jurisdictions disagree over income allocations attributable to transfer pricing. Transfer pricing adjustments assign a price, used only for allocating taxable income that most accurately reflects the amount that the same party would have charged an unrelated third party for the same goods or services. Double taxation exists because tax authorities often employ different methods for determining the appropriate income allocations attributable to transfers between related parties. But as mentioned in Section II, *infra*, the tax treaty between France and the United States provides many means to prevent a double taxation from occurring.

C- Documentation requirements

- French approach

Section 57 has been amended by a law dated 12 April 1996,⁷⁹ which also has introduced a new section – section L13B – in the Tax Procedures Code (*Livre des Procédures*

⁷⁹ Act n° 96-314, 12 April 1996 art.39 II, V Journal Officiel dated 13 April 1996.

Fiscales). The new law has introduced a number of changes with respect to procedural matters. It basically had two purposes:

- to allow the tax authorities to get more information from the taxpayer in order to make more relevant transfer pricing cases, and
- to give the tax authorities enough time to use the information that they may receive under the exchange of information procedure which is provided for by most tax treaties.

Before the entry into force of the new law, the taxpayer was not under the obligation to answer a request for information from the tax authorities. The main purpose of the new law has thus been to introduce a new procedure whereby the tax authorities have the possibility to ask for information that the taxpayer may not legally refuse to give.⁸⁰ Under this section, when the tax administration has collected information in an accounting audit that leads to the presumption that an enterprise has indirectly transferred profits abroad, the tax auditor may request from the concerned enterprise information and documents specifying:

- 1- the nature of the relationship of the French enterprise with its foreign affiliates;
- 2- the methods used for the determination of the price of the transactions carried out with such foreign affiliates and the elements justifying those methods, as well as the counterparts granted as the case may be;
- 3- the activities carried out by the enterprises mentioned above; and
- 4- the tax treatment of those activities.

⁸⁰ Bruno Gouthière, *Transfer Pricing Legislation Amended: More Control Expected*, International Bureau of Fiscal Documentation, July 1, 1996.

The key point here would be the second one: what the tax authorities would like to know is the method which has been used by the company to determine its prices.⁸¹

But again, the French system does not go as far as the U.S. system: the information that the taxpayer has to disclose is related only to the method of determining its transfer prices but it does not have to show that this method was the best method in the context.

A large number of French groups involved in cross-border transactions with affiliated companies long awaited the French tax administration's comments on the implementation of new transfer pricing audit rules codified under section L13B of the Tax Procedures Code.

The 1998 instruction⁸² comments on the conditions for information requests, the level of information that businesses must provide, and the consequences of a taxpayer's failure to respond. The comments underline that the powers granted to the tax auditor under section L13B should be used only if the audited company refuses to answer questions during an audit. It is not possible for the tax inspector to ask for information before commencing a tax audit. Then, in order to be legally able to send a request, the tax authorities must have sufficient documents in their files to presume that a taxpayer has transferred profits outside of France within the meaning of Section 57.⁸³ However, the tax authorities do not really need to prove the existence of a transfer of profits before sending a request. They need to demonstrate only that they have gathered sufficient information to show that the transfer of profits is likely and that their request is reasonable.⁸⁴

⁸¹ *Id.*

⁸² Instr. 13 L-7-98 dated July 23, 1998.

⁸³ *Id.*

⁸⁴ *Id.*

It is also important to note that the tax administration has no obligation to disclose the reasons for presuming an indirect transfer of profits abroad. They need to gather the information only in case the issue is put before the courts, because they then would have to justify that they had relevant evidence to base a serious assumption before sending the request. Without this presumption, section L13B should not be applicable.

It is important to note that unlike the U.S. legislation, the taxpayer is legally held to give information only upon request. Information does not have to be disclosed if there is no request.

- U.S. approach

In early 1994, the Treasury Department published temporary regulations under Sections 6662 and 6664 regarding penalties designed to promote compliance with the arm's length standard of Section 482. Under these new rules, if the IRS successfully asserts adjustments to the taxpayer's tax liability under Section 482, and either the overall adjustments under Section 482 exceed certain threshold amounts or the reported transfer prices varied from the adjusted transfer prices by certain percentage amounts, then penalties may be imposed, unless the taxpayer qualifies for the "reasonable cause and good faith" exception.⁸⁵

Congress has also established new reporting and documentation requirements to assist the IRS in the implementation of its Section 482 authority:

- Section 6038A provides authority to require annual reporting by U.S. corporations that are 25% foreign-owned.

⁸⁵ See I.R.C. Section 6662 (e)(3)(B)(i) (excluding from the threshold determination increases in prices for which the taxpayer acted in good faith and with reasonable cause); I.R.C. Section 6664(c) (providing a general reasonable cause and good faith exception).

- Section 6038C provides authority to require additional reporting with respect to foreign corporations engaged in a U.S. business.

The demanding requirements of Section 6038A and Section 6038C may be summarized as follows:⁸⁶

- Any foreign corporation that is engaged in a trade or business within the United States and any U.S. corporation that is 25% foreign-owned is required to file an annual information return indicating:
 - 1- the name, principal place of business, nature of business and countries in which any related party is organized or resident;
 - 2- the manner in which the reporting corporation is related to each party; and
 - 3- transactions with foreign parties that are related to the reporting corporation.
- Each reporting corporation is required to maintain books and records, and these documents must be maintained either in the United States or, if outside the United States, under an agreement permitting ready access to them by the IRS.
- The records must reflect an overview of the business, its organizational structure, an analysis of the economic and legal factors affecting pricing, a description of alternative pricing methods considered and the reasons for not using them, a description of all controlled transactions, and a description of all uncontrolled comparables considered.

⁸⁶ See Treas.Reg. § 1.6038A-1(a) and (c), and Treas.Reg. § 1.6038A-2(b).

Moreover, the taxpayer must produce such records within 30 days of any request by the IRS. Failure to comply with these rules may result in substantial monetary penalties⁸⁷ (\$10,000 for each taxable year) and in some cases may permit the IRS to determine unilaterally the reporting corporation's taxable income from the related party transactions.⁸⁸

The constraints due to the declarative obligations system established by the IRS may raise practical difficulties for foreign firms, and especially for French companies because of the French Act of July 26th, 1968, which forbids the disclosure of many documents which would prejudice the essential economic interests of France.

SECTION II- SOLUTIONS PROPOSED BY BOTH COUNTRIES

Solutions to the problems raised in Section I may result from the 1994 tax treaty between France and the United States, from a procedure called an advance pricing agreement that France seems eventually to be willing to develop. Arbitration can also be an alternative solution.

A- Mutual Agreement Procedure

Tax treaties signed by France generally follow Article 9, the "Associated enterprises" article, of the Organization for Economic Cooperation and Development Model Convention, although they usually omit the second paragraph of Article 9, which provides that, whenever a state readjusts the book recording of transactions involving

⁸⁷ Treas.Reg. § 1.6038A-4.

⁸⁸ For further details about information reporting and recordkeeping requirements for foreign-owned corporations, see John V. Pridjian, Using a Shotgun When a Pistol Would Do – An Examination of the Information Reporting and Recordkeeping Requirements (Section 6038A Regulations), 11 *Va. Tax Rev.* 427 (1991).

transfer prices between related companies, the other state shall make the necessary adjustment to avoid double taxation. Omission of this paragraph means that the French tax authorities will make a corresponding adjustment only if and to the extent that they accept the principle and amount of the price adjustment. There is no automatic adjustment of taxes.

Assume for example that taxing authorities in France conclude that prices charged by a U.S. parent for sales to a French subsidiary were too high. An adjustment is made which increases the tax liability of the French subsidiary. However the U.S. parent has already determined its U.S. tax liability based on the transfer price that was actually charged and collected. Since the taxpayer cannot compel the IRS to effect an adjustment under Section 482, the net result may well be that both countries tax the same element of income earned by the two related companies.

A correlative adjustment would be a solution to this. It means that the United States should grant an adjustment tantamount to the amount adjusted by the tax authorities in France. But unlike the U.S. system, when France initiates an adjustment to, for example, a French parent company, no special adjustments are made for subsequent dividends coming back from the foreign company. This type of issue is usually resolved by the mutual agreement procedure stated in most tax treaties.

In the case at hand, a treaty was signed on August 31, 1994, between France and the United States for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital. The tax treaty between France and the United States provides an example of a form of agreement to cooperate in exercising the power to adjust transfer prices.

Article 9 of the Treaty authorizes both countries to challenge transfer prices between “associated enterprises”.

Article 9 provides:

“1. Where:

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but by reason of those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the other Contracting State agrees that the profits so included are the profits that would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those that would have been made between independent enterprises, then that other State shall, in accordance with the provisions of

Article 26 (Mutual Agreement Procedure), make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Convention.”

Thus the tax convention specifically raises the issue of transfer pricing, and refers to Article 26 as a solution. Consequently, “where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of the convention, he may, irrespective of the remedies provided by domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national.”⁸⁹ Article 26 provides for the competent authorities of the two countries to endeavor to apply their laws, including transfer-pricing requirements, in such a way as to avoid taxation not in accordance with the tax treaty. This provision may be invoked in situations where tax officials of the two countries are contending for inconsistent adjustments based on transactions between related entities.

Assume, for example, that a U.S. corporation sells goods to a French subsidiary for \$100 per unit. The IRS, asserting its authority under Section 482, says that the correct price should be \$120. The French tax administration, asserting similar authority under Section 57, contends that the correct price should be \$80 per unit.

According to the mutual agreement procedure, the competent authorities of the two countries will consult to determine a price that will apply in both countries. However, it is important to point out that this procedure is limited in its effects as the States are compelled only to negotiate: they are not bound to reach an agreement. If the competent authorities fail to reach an agreement, the taxpayer may be subject to double taxation.

The U.S. competent authority may make a unilateral adjustment but is not required to do so. If no settlement is reached, the taxpayer may still submit his claim in the usual way, i.e. pursue administrative and judicial review otherwise available in France or in the United States, according to each peculiar situation. It is interesting to note that a taxpayer cannot generally initiate an adjustment. However, when a tax treaty provides for competent authority consideration, the taxpayer may request it.

While the mutual agreement procedure, when initiated, results most often in a compromise between the authorities of each state, it is nevertheless an expensive and time-consuming procedure.

In the United States, the following statistics applied a few years ago:

- 86% of cases were settled with full relief from double taxation,
- 8% with partial relief, and
- 6% with no relief.⁹⁰

B- Advance Pricing Agreement

An advance pricing agreement (APA) is an agreement entered into between a taxpayer and the tax authorities in advance of controlled transactions.

Until 1999, the French tax authorities showed little enthusiasm for entering into advance transfer pricing agreements and did not seem to be ready to negotiate such agreements with the IRS. But on September 17, 1999, France's tax authorities⁹¹ published an

⁸⁹ Convention for the Avoidance of Double Taxation, Aug. 31, 1994, U.S.-Fr., Article 26.

⁹⁰ CROSS-BORDER TRANSACTIONS BETWEEN RELATED COMPANIES 275 (William R. Lawlor ed., 1985).

⁹¹ the General Tax Directorate (*la Direction Générale des Impôts*)

instruction regarding advance pricing agreement procedures⁹² that incorporates many features of the U.S. Advance Pricing Agreement Program,⁹³ including critical assumptions, pre-filing conferences, and annual compliance reports. France's Ministry of Finance acknowledges that "existing tax authority audit methods pertaining to the transfer pricing practices of companies can be a source of uncertainty and trouble for these companies."⁹⁴ Therefore the new administrative regulation sets out new procedures that formalize and regularize the process in order to reduce the difficulties faced by companies in the pricing of goods and services purchased from or sold to foreign affiliates subject to possible scrutiny under Section 57 of the General Tax Code.

An advance pricing agreement determines basically the following issues:

- The factual nature of certain transactions entered into by the taxpayer and one or more foreign related companies. The scope of an APA may concern all transactions between related companies that could fall under Section 57 of the General Tax Code or Section 482 of the Internal Revenue Code, i.e. transactions concerning tangible or intangible assets or services.
 - An appropriate transfer pricing method to be applied to these transactions.
- What is important to note is that an APA does not determine the price to apply but the method to fix such a price, which, of course, must be congruent with the arm's length standard. Indeed, an APA deals only with the method to be used for transfer pricing purposes and not with the determination, as such, of

⁹² Administrative Regulation 4A-8-99, dated September 7, 1999, B.O.I, 09/17/1999, n° 171. For a translation provided by Deloitte & Touche, Paris, see *French Ministry of Finance's Guidelines on APAs*, 12 TM-TPR 544, Oct.13, 1999.

⁹³ which itself follows the OECD rules.

⁹⁴ *Id.*

the prices of intragroup transactions within a multinational group of companies.

- In addition, in most cases, the APA will cover the expected range of results of applying the transfer pricing method to the transactions. The taxpayer is required to explain the way the methodology chosen can adapt to specific changes that can affect the business conditions contained in the proposed APA. The enterprise must explain how the prices may be modified in the future in order to take into account the evolution of the economic and operational conditions of carrying out the transactions. As a consequence, the enterprise has to propose so-called “basic hypotheses,”⁹⁵ i.e. thresholds and parameters which may lead to a modification of the method and may result in its revision or suspension.⁹⁶

Thus both countries follow the OECD definition according to which an APA is an advance arrangement that determines an appropriate set of criteria (method, comparables and appropriate adjustments thereto, as well as critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time.

The French regulations do not establish a priority of order and consider, on the contrary, that any method may be acceptable, provided it meets the arm's length principle and is adequately documented. As an example, the regulations demand that the following information be disclosed to the tax authorities:

⁹⁵ the equivalent of the “critical assumptions” under the U.S. approach.

⁹⁶ For more information about the scope of an advance pricing agreement, see Bruno Gouthière, *Advance Pricing Agreements Introduced*, International Bureau of Fiscal Documentation, vol.40, n°3, 2000.

- functional analysis, assets used by the entities involved in the transactions, economic costs and risks assumed;
- analysis and economic studies related to the determination of the prices in the relevant economic sector, within the geographical area covered by the APA;
- list of competitors and study of certain uncontrolled transactions;
- detailed description of the research made to identify comparables, and
- detailed description of how the comparables have been adjusted so as to determine a proper methodology.

Unlike in the United States, there is no possibility in France to get a unilateral APA, i.e. an APA negotiated only between the enterprise and its own tax authorities. An APA, under the French regulations, is always bilateral in the sense that it is an agreement between the competent authorities of France and another state.⁹⁷ The French program precludes indeed the negotiation of unilateral APAs as it sets forth a mutual agreement procedure similar to the one established by Article 25 of the 1992 OECD Model Treaty. It restricts APAs to situations in which the other country involved is a treaty partner, and taxpayers will have to ensure that their request is potentially acceptable to the tax authorities on both sides of the transaction.⁹⁸

The APA program is a voluntary program, and it is the taxpayer that decides whether or not to apply for an APA with the tax authorities of his country. It represents an opportunity for the taxpayer to negotiate with the tax administration before the implementation of transactions with respect to a range of approved intercompany pricing results. The intent of an APA procedure is to provide relative certainty to taxpayers as to

⁹⁷ *Id.*

the standards by which transactions will be evaluated, and thus as to the prices of their transactions.

One of the difficulties of the procedure is that there is no certainty that the requesting company will get the approval of the authorities. There is no obligation for them to deliver the APA as requested, nor any obligation for the taxpayer to finally agree with what is proposed to it by the tax authorities. However, an APA is a binding agreement between the taxpayer and the tax authorities, and once the APA is entered into, “if the taxpayer complies with the terms and conditions of the APA, the tax authorities will regard the results of applying the transfer pricing methodology as satisfying the arm's length standard, and therefore will not contest the application of the transfer pricing methodology to the subject matter of the APA.”⁹⁹

During the time of the agreement, the taxpayer will be assured that no adjustment will be proposed under Sections 57 and 482. However, under the U.S. approach, the APA process may be easily criticized:

- the cost of developing and maintaining an APA is substantial, while there is no charge for requesting an APA in France.
- under the French regulations, the APA process is available to all companies without any income requirement, unlike the U.S. legislation.
- the procedure is time-consuming. The IRS had reported that the APA process is likely to take 10 to 12 months to complete. Involvement of foreign tax authorities, however, may substantially delay finalizing the APA.

⁹⁸ For a brief sum-up of the French new regulations, see *Guidelines on Advance Pricing Agreements published*, 1999 IBFD News FRANCE, October 25, 1999.

⁹⁹ Revenue Procedure 91-22, 1991-1 C.B. 526.

- The taxpayer must comply with numerous declarative obligations and negotiations with the IRS.

The IRS announced in May 2001 that the Advance Pricing Agreement Program completed a record 21 APAs in the first quarter of 2001, whose completion meant that the APA Program has passed the 200 mark for finalizing advance agreements.¹⁰⁰ The IRS completed a record 63 APAs in the 2000 calendar year¹⁰¹ (and 61 in fiscal year 2000 that ended September 30).¹⁰² The study shows that the IRS required six years and three months to complete its first 100 APAs, reaching that milestone in June 1997. It took three years and nine months to complete its second 100 accords.¹⁰³ The 21 completed agreements included nine bilateral and fifteen unilateral APAs. As of March 31, 2001, 203 APA matters were pending at various stages of development, 167 bilateral and 36 unilateral.¹⁰⁴

Since the regulations have been issued only recently in France, there is no experience yet with APAs. But in the future, it is likely that the APAs with the United States will be favored.

Because of the above concerns relating to the APA process, taxpayers should devote sufficient time and reflection in determining whether involvement in the APA process is the right course of action with any set of pricing issues. The tax treaty between France and the United States provides that if an agreement cannot be reached by the

¹⁰⁰ *Advance Pricing Agreements: IRS Has Record 21 APAs in First Quarter; Program Passes 200-completed Milestone*, 2 TM-TPR 35 (2001).

¹⁰¹ *Advance Pricing Agreements: IRS Completed 63 APAs in 2000, breaks 1999 record of 1960, Foley says* (Foley is the APA Program Director), 19 TM-TPR 680, Feb. 7, 2001.

¹⁰² *Advance Pricing Agreements: IRS completes 61 APAs in FY 2000, breaking previous record of 51 for FY 1998*, 15 TM-TPR, Nov. 29, 2000.

¹⁰³ For further details, see 6 TM-TPR 205.

competent authorities under the mutual agreement procedure, the case may, if both the competent authorities and the taxpayer agree, be submitted to arbitration.¹⁰⁵

C- Arbitration

The use of the mutual agreement procedure is not always satisfactory for the taxpayer. As a matter of fact, as noted above, the competent authorities are bound only to negotiate and not to reach an agreement. If they cannot reach an agreement, the double taxation remains, while the purpose of a tax treaty is to eliminate this burden.

Arbitration is an interesting way to resolve different viewpoints. It can successfully be used to resolve transfer-pricing cases, as both governments have an interest in the resolution of conflicting positions regarding transfer-pricing controversies. However, the recourse to the arbitration procedure provided by the treaty is quite arbitrary, in the sense that it is totally at the discretion of the competent authorities. If the competent authorities do not want to go to arbitration, the taxpayer cannot compel them to do so. In this respect, the solution is clearly much less favorable than that provided under the European Union Arbitration Convention of 1990 that is in force (as of January 1, 1995) between the countries within the European Union.¹⁰⁶

Under the Arbitration Convention, arbitration is compulsory if the mutual agreement has failed. The decision of the arbitration board is binding, except if the two states agree on another solution, but they nevertheless have to avoid double taxation. Further, if a competent authority case is not completed within two years from the date on which the taxpayer presented its case, the case goes to an advisory commission for

¹⁰⁴ For information on APAs and the APA Program from 1991 to 1999, see IRS First Annual Report on Advance Pricing Agreement (Announcement 2000-35, released 3/30/00), 24 TM-TPR 1020, April 15, 2000.

¹⁰⁵ Article 26 (5) of the 1994 Tax Treaty between France and the United States.

binding arbitration. The Arbitration Convention provides for the first time a clear right of the taxpayer to the elimination of double taxation, which is unfortunately not the case between France and the United States.

The absence of a binding arbitration procedure is regrettable, as arbitration can sometimes be an alternative solution to potential transfer pricing issues, as shown in the following example.

In a case involving a Singapore subsidiary of Apple Computer, Inc., it has been observed that:

- Apple's time to decision was reduced by about 4 years compared with the time required for a judicial trial and appeal;
- that Apple's legal fees were \$4 to \$5 million less than they would have been in litigation;
- and that Apple had the benefit of confidentiality, which would have been sacrificed in a trial with a public record.¹⁰⁷

Thus arbitration provides many advantages. It functions as an alternative to judicial litigation, by providing binding determinations through presumably less expensive, more efficient and expert, and nonetheless fair proceedings. However, according to a survey of multinational companies released by Ernst & Young LL.P. on November 3, 1999,¹⁰⁸ it has been observed that resolution of competent authority disputes is taking longer than in the past. The survey said that almost half of the 706 respondents reported that their

¹⁰⁶ See Bruno Gouthière, *New Tax Treaty With the United States*, International Bureau of Fiscal Documentation, Vol.35, No 3, 1995.

¹⁰⁷ See Fuller, *Apple Arbitration*, 7 Tax Notes Int'l 1046-47 (1993).

¹⁰⁸ *Competent Authority: Disputes Taking Longer to Resolve*, 14 TM-TPR 630, Nov. 10, 1999.

competent authority relief request required between 2 and 5 years to resolve. Three percent said it required 10 to 15 years to resolve their relief requests.

The 1999 survey said 11% of the companies responding reported using a claim under the competent authority provision of a double tax treaty. Highest use of competent authority was made by the U.S. companies with 24% of the multinationals reporting claims. Eleven percent of the 27 French multinationals reported using their country's competent authority procedure.¹⁰⁹

Although there is likely a trend in recent treaties to encourage arbitration, it is important to note that such treaties contain provisions authorizing, but not requiring, the resort to binding arbitration if the competent authorities cannot negotiate a price acceptable to both sides.

¹⁰⁹ *Id.*

CHAPTER 4

CONCLUSION

Both in France and in the United States, transfer pricing is a matter of increasing concern, particularly on account of the uncertainty it causes for taxpayers, the tax authorities, and the courts.

On the one hand, the U.S. Congress enacted Section 482 of the Internal Revenue Code and numerous regulations in order to prevent tax avoidance offered by transfer pricing manipulations. The Tax Reform Act of 1986¹¹⁰ revised I.R.C. Section 482 to require that the consideration for the intercompany transfer of intangible property be based on a “commensurate with income” standard. This was followed in October 1988 by the issuance of a transfer pricing study, known as “White Paper”.¹¹¹ Taxpayer comments on the White Paper were used to formulate proposed regulations. The 1992 Proposed Regulations¹¹² to I.R.C. Section 482 were the culmination of the IRS’ continued effort to ensure that corporations are charging a fair amount for the transfer of goods or services between related parties.

In 1993, the IRS released a set of temporary regulations on the issue of intercompany transfer pricing of tangible and intangible property, taking into consideration the 1992 Proposed Regulations. At last, after lengthy discussion, new regulations were issued in final form from 1994 through 1996.

¹¹⁰ Pub. L. No 99-514, 100 Stat. 2095 (1986).

¹¹¹ I.R.S. Notice 88-123, 1988-2 C.B. 458.

¹¹² 57 Fed. Reg. 3571 (1992).

On the other hand, although France was one of the very first countries to introduce transfer-pricing legislation (the legislation dates back to 1933), France plays the role of a poor relation in the international context, with little or no theoretical analysis of the subject. Case law remains very fragmented, if not insignificant, and the administrative practice seems to approach this issue with considerable reserve and caution.¹¹³

The legal principles applicable to transfer pricing issues do not cause any particular difficulty. But the practical application of the principles, however, requires a subtle analysis of economic situations, an analysis especially difficult to carry out given the former means available to the French administration. However, since France imposed transfer pricing documentation requirements in April 1996 and issued an administrative regulation in July 1998 that expanded the 1996 documentation requirements, the tax authorities now have more power to make their investigations, and the administration may be soon in a position that will allow it to produce the facts needed to make a convincing comparison and to prove the elements necessary to establish a transfer of profits. It will likely put the tax authorities in a better position to make a stronger transfer pricing case when the dispute eventually goes to court.

France seems to be more concerned with transfer pricing issues than in the past. It even recently showed its interest in the subject by introducing a new advance pricing agreement process, although it has not been possible so far to get individual rulings with regard to transfer pricing.

Considering the importance of the U.S. transfer pricing system in business life and on the other industrialized countries' attitudes, it is not surprising that the French

¹¹³ Gauthier Blanluet, *Transfer Pricing: Theory and Practice*, International Bureau of Fiscal Documentation, Vol. 32, No 1, 1992.

authorities decided to follow it in large parts when modernizing their own legislation.

At present France follows the general trend of OECD countries and it is likely that in France, transfer-pricing issues will be of greater importance in the coming years.

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APPENDIX A

CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNEMENT OF THE FRENCH REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

The Government of the United States of America and the Government of the French Republic, desiring to conclude a new convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, have agreed as follows:

Article 1--Personal Scope

This Convention shall apply only to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

Article 2--Taxes Covered

1. The taxes which are the subject of this Convention are:

(a) in the case of the United States:

(i) the Federal income taxes imposed by the Internal Revenue Code (but excluding social security taxes); and

(ii) the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations (hereinafter referred to as "United States tax"). The Convention, however, shall apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to exemption from such taxes under this or any other income tax convention which applies to these taxes;

(b) in the case of France, all taxes imposed on behalf of the State, irrespective of the manner in which they are levied, on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, as well as taxes on capital appreciation, in particular:

(i) the income tax (l'impôt sur le revenu);

(ii) the company tax (l'impôt sur les sociétés);

(iii) the tax on salaries (la taxe sur les salaires) governed by the provisions of the Convention applicable, as the case may be, to business profits or to income from independent personal services; and

(iv) the wealth tax (l'impôt de solidarité sur la fortune) (hereinafter referred to as "French tax"). 2. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions.

Article 3--General Definitions

1. For the purposes of this Convention:

(a) the term "Contracting State" means the United States or France, as the context requires;

(b) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory. When used in a geographical sense, the term "United States" means the states thereof and the District of Columbia and includes the territorial sea adjacent to those States and any area outside the territorial sea within which, in accordance with international law, the United States has sovereign rights for the purpose of exploring and exploiting the natural resources of the seabed and its subsoil and the superjacent waters;

(c) the term "France" means the French Republic and, when used in a geographical sense, means the European and Overseas Departments of the French Republic and includes the territorial sea and any area outside the territorial sea within which, in accordance with international law, the French Republic has sovereign rights for the purpose of exploring and exploiting the natural resources of the seabed and its subsoil and the superjacent waters;

(d) the term "person" includes, but is not limited to, an individual and a company;

(e) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

(f) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

(g) the term "international traffic" means any transport by a ship or aircraft, except when the ship or aircraft is operated solely between places in a Contracting State;

(h) the term "competent authority" means:

(i) in the United States, the Secretary of the Treasury or his delegate;
and

(ii) in France, the Minister in charge of the budget or his authorized representative.

2. As regards the application of the Convention by a Contracting State, any term not defined herein shall, unless the competent authorities agree to a common meaning

pursuant to the provisions of Article 26 (Mutual Agreement Procedure), have the meaning which it has under the taxation laws of that State.

Article 4--Resident

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State, or of capital situated therein.

2. (a) France shall consider a U.S. citizen or an alien admitted to the United States for permanent residence (a "green card" holder) to be a resident of the United States for the purposes of paragraph 1 only if such individual has a substantial presence in the United States or would be a resident of the United States and not of a third State under the principles of subparagraphs (a) and (b) of paragraph 3.

(b) The term "resident of a Contracting State" includes:

(i) that State, a political subdivision (in the case of the United States) or local authority thereof, and any agency or instrumentality of such State, subdivision, or authority;

(ii) a pension trust and any other organization established in that State and maintained exclusively to administer or provide retirement or employee benefits that is established or sponsored by a person that is a resident of that State under the provisions of this Article; and any not-for-profit organization established and maintained in that State, provided that the laws of such State or (in the case of the United States) a political subdivision thereof limit the use of the organization's assets, both currently and upon the dissolution or liquidation of such organization, to the accomplishment of the purposes that serve as the basis for such organization's exemption from income tax; notwithstanding that all or part of the income of such trust, other organization, or not-for-profit organization may be exempt from income taxation in that State;

(iii) in the case of the United States, a regulated investment company, a real estate investment trust, and a real estate mortgage investment conduit; in the case of France, a "societe d'investissement a capital variable" and a "fonds commun de placement"; and any similar investment entities agreed upon by the competent authorities of both Contracting States;

(iv) a partnership or similar pass-through entity, an estate, and a trust (other than one referred to in subparagraph (ii) or (iii) above), but only to the extent that the income derived by such partnership, similar entity, estate, or trust is subject to tax in the Contracting State as the income of a resident, either in the hands of such partnership, entity, estate, or trust or in the hands of its partners, beneficiaries, or grantors, it being understood that a "societe de personnes," a "groupement d'interet economique" (economic interest group), or a "groupement europeen d'interet economique" (European economic interest group) that is constituted in France and has its place of effective management in France and that is not subject to company tax therein shall be treated as a partnership for purposes of United States tax benefits under this Convention.

3. Where, by reason of the provisions of paragraphs 1 and 2, an individual is a resident of both Contracting States, his status shall be determined as follows:

(a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both

Contracting States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);

(b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

(c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

(d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

4. Where, by reason of the provisions of paragraphs 1 and 2, a person other than an individual is a resident of both Contracting States, the competent authorities shall endeavor to settle the question by mutual agreement, having regard to the person's place of effective management, the place where it is incorporated or constituted, and any other relevant factors. In the absence of such agreement, such person shall not be considered to be a resident of either Contracting State for purposes of enjoying benefits under this Convention.

Article 5--Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop; and

(f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. The term "permanent establishment" shall also include a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or to prepare for the extraction of natural resources, but only if such site or project lasts, or such rig or ship is used, for more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

(e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

(f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person--other than an agent of an independent status to whom paragraph 6 applies--is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business as such.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6--Income from Real Property

1. Income from real property (including income from agriculture or forestry) situated in a Contracting State may be taxed that State.

2. The term "real property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include options, promises to sell, and similar rights relating to real property, property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships and aircraft shall not be regarded as real property.

3. The provisions of paragraph 1 shall apply to income from the direct use, letting, or use in any other form of real property.

4. The provisions of paragraphs 1 and 3 shall also apply to income from real property of an enterprise and to income from real property used for the performance of independent personal services.

5. Where the ownership of shares or other rights in a company entitles a resident of a Contracting State to the enjoyment of real property situated in the other Contracting State and held by that company, the income derived by the owner from the direct use, letting, or use in any other form of this right of enjoyment may be taxed in that other State to the

extent that it would be taxed under the domestic law of that other State if the owner were a resident of that State. The provisions of this paragraph shall apply, notwithstanding the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services).

6. A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect to be taxed on a net basis, if such treatment is not provided under the domestic law of that other State.

Article 7--Business Profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are reasonably connected with such profits, including executive and general administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. A partner shall be considered to have realized income or incurred deductions to the extent of his share of the profits or losses of a partnership, as provided in the partnership agreement (provided that any special allocations of profits or losses have substantial economic effect). For this purpose, the character (including source and attribution to a permanent establishment) of any item of income or deduction accruing to a partner shall be determined as if it were realized or incurred by the partner in the same manner as realized or incurred by the partnership.

5. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

6. For the purposes of the preceding paragraphs of this Article, the profits to be attributed to the permanent establishment shall include only the profits or losses derived from the assets or activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Any profit attributable to a permanent establishment, according to the provisions of this Article, during its existence may be taxed in the Contracting State in which such permanent establishment is situated, even if the payments are deferred until such permanent establishment has ceased to exist.

8. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 8--Shipping and Air Transport

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic include:

(a) profits of the enterprise derived from the rental on a full basis of ships or aircraft operated in international traffic, and profits of the enterprise derived from the rental on a bareboat basis of ships or aircraft if such ships or aircraft are operated in international traffic by the lessee or such rental profits are accessory to other profits described in paragraph 1; and

(b) profits of the enterprise from the use, maintenance or rental of containers used in international traffic (including trailers, barges, and related equipment for the transport of such containers) if such profits are accessory to other profits described in paragraph 1.

3. The provisions of paragraphs 1 and 2 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.

Article 9--Associated Enterprises

1. Where:

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the other Contracting State agrees that the profits so included are profits that would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those that would have been made between independent enterprises, then that other State shall, in accordance with the provisions of Article 26 (Mutual Agreement Procedure), make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Convention.

Article 10--Dividends

1. Dividends paid by a company that is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. Such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

(a) 5 percent of the gross amount of the dividends if the beneficial owner is a company that owns:

(i) directly, at least 10 percent of the voting power in the company paying the dividends, if such company is a resident of the United States; or

(ii) directly or indirectly, at least 10 percent of the capital of the company paying the dividends, if such company is a resident of France;

(b) 15 percent of the gross amount of the dividends in other cases.

The provisions of subparagraph (a) shall not apply in the case of dividends paid by a United States regulated investment company or real estate investment trust or by a French "société d'investissement à capital variable." In the case of dividends paid by a United States regulated investment company or a French "société d'investissement à capital variable," the provisions of subparagraph (b) shall apply. In the case of dividends paid by a United States real estate investment trust, the provisions of subparagraph (b) shall apply only if the dividend is beneficially owned by an individual owning a less than 10 percent interest in such real estate investment trust; otherwise, the rate of withholding tax applicable under the domestic law of the United States shall apply.

3. The provisions of paragraph 2 shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

4. (a) A resident of the United States who derives and is the beneficial owner of dividends paid by a company that is a resident of France that, if received by a resident of France, would entitle such a resident to a tax credit ("avoir fiscal") shall be entitled to a payment from the French Treasury equal to such tax credit ("avoir fiscal"), subject to deduction of the tax provided for in subparagraph (b) of paragraph 2.

(b) The provisions of subparagraph (a) shall apply only to a resident of the United States that is:

(i) an individual or other person (other than a company); or

(ii) a company that is not a regulated investment company and that does not own, directly or indirectly, 10 percent or more of the capital of the company paying the dividends; or

(iii) a regulated investment company that does not own, directly or indirectly, 10 percent or more of the capital of the company paying the dividends, but only if less than 20 percent of its shares is beneficially owned by persons who are neither citizens nor residents of the United States.

(c) The provisions of subparagraph (a) shall apply only if the beneficial owner of the dividends is subject to United States income tax in respect of such dividends and of the payment from the French Treasury.

(d) Notwithstanding the provisions of subparagraphs (b) and (c), the provisions of subparagraph (a) shall also apply to a partnership or trust described in subparagraph (b)(iv) of paragraph 2 of Article 4 (Resident), but only to the extent that the partners, beneficiaries, or grantors would qualify under subparagraph (b)(i) or (b)(ii) and under subparagraph (c) of this paragraph.

(e)(i) A resident of the United States described in subparagraph (ii) that does not own, directly or indirectly, 10 percent or more of the capital of a company that is a resident of France, and that derives and beneficially owns dividends paid by such company that, if derived by a resident of France, would entitle such resident to a tax credit ("avoir fiscal"), shall be entitled to a payment from the French Treasury equal to 30/85 of the amount of such tax credit ("avoir fiscal"), subject to the deduction of the tax provided for in subparagraph (b) of paragraph 2;

(ii) The provisions of subparagraph (i) shall apply to:

(aa) a person described in subparagraph (b)(i) of paragraph 2 of Article 4 (Resident), with respect to dividends derived by such person from the investment of retirement assets;

(bb) a pension trust and any other organization described in subparagraph (b)(ii) of paragraph 2 of Article 4 (Resident); and

(cc) an individual, with respect to dividends beneficially owned by such individual and derived from investment in a retirement arrangement under which the contributions or the accumulated earnings receive tax-favored treatment under U.S. law.

(f) The gross amount of a payment made by the French Treasury pursuant to subparagraph (a), (d), or (e) shall be deemed to be a dividend for the purposes of this Convention.

(g) The provisions of subparagraphs (a), (d), and (e) shall apply only if the beneficial owner of the dividends shows, where required by the French tax administration, that he is the beneficial owner of the shareholding in respect of which the dividends are paid and that such shareholding does not have as its principal purpose or one of its principal purposes to allow another person to take advantage of the provisions of this paragraph, regardless of whether that person is a resident of a Contracting State.

(h) Where a resident of the United States that derives and beneficially owns dividends paid by a company that is a resident of France is not entitled to the payment from the French Treasury referred to in subparagraph (a), such resident may obtain a refund of the prepayment (précompte) to the extent that it was actually paid by the company in respect of such dividends. Where such a resident is entitled to the payment from the French Treasury referred to in subparagraph (e), such refund shall be reduced by the amount of the payment from the French Treasury. The gross amount of the prepayment (precompte) refunded shall be deemed to be a dividend for the purposes of the Convention. It shall be taxable in France according to the provisions of paragraph 2.

(i) The competent authorities may prescribe rules to implement the provisions of this paragraph and further define and determine the terms and conditions under which the payments provided for in subparagraphs (a), (d), and (e) shall be made.

5. (a) The term "dividends" means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income treated as a distribution by the taxation laws of the State of which the company making the distribution is a resident; and income from arrangements, including debt obligations, that carry the right to participate in, or are determined with reference to, profits of the issuer or one of its associated enterprises, as defined in subparagraph (a) or (b) of paragraph 1 of Article 9 (Associated Enterprises), to the extent that such income is characterized as a dividend under the law of the Contracting State in which the income arises. The term "dividend" shall not include income referred to in Article 16 (Directors' Fees).

(b) The provisions of this Article shall apply where a beneficial owner of dividends holds depository receipts evidencing ownership of the shares in respect of which the dividends are paid, in lieu of the shares themselves.

6. The provisions of paragraphs 1 through 4 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to

such permanent establishment or fixed base. In such a case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

7. (a) A company that is a resident of a Contracting State and that has a permanent establishment in the other Contracting State or that is subject to tax on a net basis in that other State on items of income that may be taxed in that other State under Article 6 (Income from Real Property) or under paragraph 1 of Article 13 (Capital Gains) may be subject in that other State to a tax in addition to the other taxes allowable under this Convention. Such tax, however, may not exceed 5 percent of that portion of the business profits of the company attributable to the permanent establishment, or of that portion of the income referred to in the preceding sentence that is subject to tax under Article 6 or paragraph 1 of Article 13, that:

(i) in the case of the United States, represents the "dividend equivalent amount" of those profits or income, in accordance with the provisions of the Internal Revenue Code, as it may be amended from time to time without changing the general principle thereof;

(ii) in the case of France, is included in the base of the French withholding tax in accordance with the provisions of Article 115 "quinquies" of the French tax code (code general des impots) or with any similar provisions which amend or replace the provisions of that Article.

(b) The taxes referred to in subparagraph (a) also shall apply to the portion of the business profits, or of the income subject to tax under Article 6 (Real Property) or paragraph 1 of Article 13 (Capital Gains) that is referred to in subparagraph (a), which is attributable to a trade or business conducted in one Contracting State through a partnership or other entity treated as a pass-through entity or transparent entity under the laws of that State by a company that is a member of such partnership or entity and a resident of the other Contracting State.

8. Subject to the provisions of paragraph 7, where a company that is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the dividends are attributable to a permanent establishment or fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11--Interest

1. Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. Notwithstanding the provisions of paragraph 1:

(a) interest arising in a Contracting State that is determined with reference to the profits of the issuer or of one of its associated enterprises, as defined in subparagraph (a) or (b) of paragraph 1 of Article 9 (Associated Enterprises), and paid to a resident of the other Contracting State may be taxed in that other State;

(b) however, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner is a resident of the other Contracting State, the gross amount of the interest may be taxed at a rate not exceeding the rate prescribed in subparagraph (b) of paragraph 2 of Article 10 (Dividends).

3. The term "interest" means income from indebtedness of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures, as well as other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises. However, the term "interest" does not include income dealt with in Article 10 (Dividends). Penalty charges for late payment shall not be regarded as interest for the purposes of the Convention.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State, in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount that would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 12--Royalties

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. Such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed 5 percent of the gross amount of the royalties.

3. Notwithstanding the provisions of paragraph 2, royalties described in subparagraph (a) of paragraph 4 that arise in a Contracting State and are beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

4. The term "royalties" means:

(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work or any neighboring right (including reproduction rights and performing rights), any cinematographic film, any sound or picture recording, or any software;

(b) payments of any kind received as a consideration for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; and

(c) gains derived from the alienation of any such right or property described in this paragraph that are contingent on the productivity, use, or further alienation thereof.

5. The provisions of paragraphs 1, 2, and 3 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State, in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

6. (a) Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State.

(b) Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

(c) Notwithstanding subparagraphs (a) and (b), royalties paid for the use of, or the right to use, property in a Contracting State shall be deemed to arise therein.

(d) Royalties shall be deemed to be paid to the beneficial owner at the latest when they are taken into account as expenses for tax purposes in the Contracting State in which they arise.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13--Capital Gains

1. Gains from the alienation of real property situated in a Contracting State may be taxed in that State.

2. For purposes of paragraph 1, the term "real property situated in a Contracting State" means:

(a) where the United States is the Contracting State, real property referred to in Article 6 (Real Property) that is situated in the United States, a United States real property interest (as defined in section 897 of the Internal Revenue Code, as it may be amended from time to time without changing the general principle thereof), and an interest in a partnership, trust, or estate, to the extent attributable to real property situated in the United States; and

(b) where France is the Contracting State,

(i) real property referred to in Article 6 (Real Property) that is situated in France; and

(ii) shares or similar rights in a company the assets of which consist at least 50 percent of real property situated in France or derive at least 50 percent of their value, directly or indirectly, from real property situated in France;

(iii) an interest in a partnership, a "société de personnes", a "groupement d'intérêt économique" (economic interest group), or a "groupement européen d'intérêt économique" (European economic interest group) (other than a partnership, a "société de personnes", a "groupement d'intérêt économique" (economic interest group), or a "groupement européen d'intérêt économique" that is taxed as a company under French domestic law), an estate, or a trust, to the extent attributable to real property situated in France.

3. (a) Gains from the alienation of movable property forming part of the business property of a permanent establishment or fixed base that an enterprise or resident of a Contracting State has in the other Contracting State, including such gains from the alienation of such permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State. Where the removal of such property from the other Contracting State is deemed to constitute an alienation of such property, the gain that has accrued as of the time that such property is removed from that other State may be taxed by that other State in accordance with its law, and the gain accruing subsequent to that time of removal may be taxed in the first-mentioned Contracting State in accordance with its law.

(b) Any gain attributable to a permanent establishment or a fixed base according to the provisions of subparagraph (a) during its existence may be taxed in the Contracting State in which such permanent establishment or fixed base is situated, even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.

4. Gains derived by an enterprise of a Contracting State that operates ships or aircraft in international traffic from the alienation of such ships or aircraft or movable property pertaining to the operation of such ships or aircraft shall be taxable only in that State.

5. Gains described in subparagraph (c) of paragraph 4 of Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12.

6. Subject to the provisions of paragraph 5, gains from the alienation of any property other than property referred to in paragraphs 1 through 4 shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14--Independent Personal Services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State unless that resident performs activities in the other Contracting State and has a fixed base regularly available to him in that other State for the purpose of performing his activities. In such a case, the income may be taxed in the other State, but only so much of it as is attributable to that fixed base, and according to the principles contained in Article 7 (Business Profits).

2. Any income attributable to a fixed base during its existence, according to the provisions of paragraph 1, may be taxed in the Contracting State in which such fixed base is situated, even if the payments are deferred until such fixed base has ceased to exist.

3. The term "professional services" includes especially independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

4. The provisions of paragraph 4 of Article 7 (Business Profits) shall apply by analogy. In no event, however, shall those provisions or the provisions of Article 4 (Resident) result in France exempting under Article 24 (Relief from Double Taxation) more than 50 percent of the earned income from a partnership accruing to a resident of France. The amount of such a partner's income which is not exempt under Article 24 (Relief from Double Taxation) 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.

Article 15--Dependent Personal Services

1. Subject to the provisions of Articles 16 (Directors' Fees), 18 (Pensions), and 19 (Public Remuneration), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

(a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned;

(b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment exercised as a member of the regular complement of a ship or aircraft operated in international traffic shall be taxable only in that State.

Article 16--Directors' Fees

Directors' fees and other remuneration derived by a resident of a Contracting State for services rendered in the other Contracting State in his capacity as a member of the board of directors of a company that is a resident of the other Contracting State may be taxed in that other State.

Article 17--Artists and Sportsmen

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artist or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State. However, the provisions of this paragraph shall not apply where the amount of the gross receipts derived by such entertainer or sportsman from such activities, including expenses reimbursed to him or borne on his behalf, does not exceed 10,000 United States dollars or its equivalent in French francs for the taxable period concerned.

2. Where income in respect of personal activities exercised by an entertainer or sportsman in his capacity as such accrues not to the entertainer or sportsman but to another person, whether or not a resident of a Contracting State, that income may, notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised. However, the provisions of this paragraph shall not apply where it is established that neither the entertainer or sportsman nor persons related to him derive from that other person any income, directly or indirectly, in respect of such activities that in the aggregate exceeds the amount specified in paragraph 1 for the taxable period concerned.

3. The provisions of paragraphs 1 and 2 shall not apply to income derived by a resident of a Contracting State as an entertainer or a sportsman from his personal activities as such exercised in the other Contracting State if the visit to that other State is principally supported, directly or indirectly, by public funds of the first-mentioned State or a political subdivision (in the case of the United States) or local authority thereof. In such case the income shall be taxable only in the first-mentioned State.

Article 18--Pensions

1. Subject to the provisions of paragraph 2 of Article 19 (Public Remuneration):

(a) except as provided in subparagraph (b), pensions and other similar remuneration, including distributions from pension and other retirement arrangements, derived and beneficially owned by a resident of a Contracting State in consideration of past employment, whether paid periodically or in a lump sum, shall be taxable only in that State;

(b) pensions and other payments made under the social security legislation of a Contracting State to a resident of the other Contracting State shall be taxable only in the first-mentioned State. Pensions and other payments made under the social security legislation of France to a resident of France who is a citizen of the United States shall be taxable only in France. The term "social security legislation" includes the Railroad Retirement Act in the case of the United States and the French social security regimes which are of a mandatory character.

2. (a) In determining the taxable income of an individual who renders personal services and who is a resident of a Contracting State but not a national of that State, contributions paid by, or on behalf of, such individual to a pension or other retirement arrangement that is established and maintained and recognized for tax purposes in the other Contracting State shall be treated in the same way for tax purposes in the first-mentioned State as a contribution paid to a pension or other retirement arrangement that is established and maintained and recognized for tax purposes in that first-mentioned State, provided that the competent authority of the first-mentioned State agrees that the pension or other retirement arrangement generally corresponds to a pension or other retirement arrangement recognized for tax purposes by that State

(b) For the purposes of subparagraph (a):

(i) where the competent authority of France agrees that a United States pension or other retirement arrangement generally corresponds to a mandatory French pension arrangement (without regard to the mandatory nature of such arrangement), it is understood that contributions to the United States pension or other retirement arrangement shall be treated in France in the same way for tax purposes as contributions to the French mandatory pension arrangement; and

(ii) where the competent authority of the United States agrees that a mandatory French pension or other retirement arrangement generally corresponds to a United States pension or other retirement arrangement (without regard to the mandatory nature of such arrangement), it is understood that contributions to the French pension or other retirement arrangement shall be treated in the United States in the same way for tax purposes as contributions to the United States pension or other retirement arrangement; and

(iii) a pension or other retirement arrangement is recognized for tax purposes in a State if the contributions to the arrangement would qualify for tax relief in that State.

(c) Payments received by a beneficiary in respect of an arrangement referred to in subparagraph (a) that satisfies the requirements of this paragraph shall be included in income for tax purposes of the Contracting State of which the beneficiary is a resident, subject to the provisions of Article 24 (Relief from Double Taxation), when and to the extent that such payments are considered gross income by the other Contracting State.

Article 19--Public Remuneration

1. (a) Remuneration, other than a pension, paid by a Contracting State, a political subdivision (in the case of the United States) or local authority thereof, or an agency or instrumentality of that State, subdivision, or authority to an individual in respect of services rendered to that State, subdivision, authority, agency, or instrumentality shall be taxable only in that State.

(b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of and a national of that State and not at the same time a national of the first-mentioned State.

2. (a) Any pension paid by, or out of funds created by, a Contracting State, a political subdivision (in the case of the United States) or local authority thereof, or an agency or instrumentality of that State, subdivision, or authority to an individual in respect of services rendered to that State, subdivision, authority, agency, or instrumentality shall be taxable only in that State.

(b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of and a national of that State and not at the same time a national of the first-mentioned State.

3. The provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees), 17 (Artistes and Sportsmen), and 18 (Pensions) shall apply to remuneration and pensions paid in respect of services rendered in connection with a business carried on by a Contracting State, a political subdivision (in the case of the United States) or local authority thereof, or an agency or instrumentality of that State, subdivision, or authority.

Article 20--Teachers and Researchers

1. An individual who is a resident of a Contracting State immediately before his visit to the other Contracting State and who, at the invitation of the Government of that other State or of a university or other recognized educational or research institution situated in that other State, visits that other State for the primary purpose of teaching or engaging in research, or both, at a university or other recognized educational or research institution shall be taxable only in the first-mentioned State on his income from personal services for such teaching or research for a period not exceeding 2 years from the date of his arrival in the other State. An individual shall be entitled to the benefits of this paragraph only once.

2. The provisions of paragraph 1 shall not apply to income from research if such research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

Article 21--Students and Trainees

1. (a) An individual who is a resident of a Contracting State immediately before his visit to the other Contracting State and who is temporarily present in the other Contracting State for the primary purpose of:

(i) studying at a university or other recognized educational institution in that other Contracting State;

(ii) securing training required to qualify him to practice a profession or professional specialty; or

(iii) studying or doing research as a recipient of a grant, allowance, or award from a not-for-profit governmental, religious, charitable, scientific, artistic, cultural, or educational organization, shall be exempt from tax in that other State with respect to amounts referred to in subparagraph (b).

(b) The amounts referred to in subparagraph (a) are:

(i) gifts from abroad for the purposes of his maintenance, education, study, research, or training;

(ii) a grant, allowance, or award described in subparagraph (a)(iii); and

(iii) income from personal services performed in the other Contracting State in an amount not in excess of 5,000 United States dollars or its equivalent in French francs for any taxable period.

(c) The benefits of this paragraph shall only extend for such period of time as may be reasonably or customarily required to effectuate the purpose of the visit, but in no event shall any individual have the benefits of this Article and Article 20 (Teachers and Researchers) for more than a total of five taxable periods.

(d) The provisions of subparagraph (a) shall not apply to income from research if such research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

2. An individual who is a resident of a Contracting State immediately before his visit to the other Contracting State, and who is temporarily present in that other State as an employee of, or under contract with, a resident of the first-mentioned State for the primary purpose of:

(a) acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned State, or

(b) studying at a university or other recognized educational institution in the other State, shall be exempt from tax by that other State for a period of 12 consecutive months with respect to his income from personal services in an aggregate amount not in excess of 8,000 United States dollars or its equivalent in French francs.

Article 22--Other Income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from real property as defined in paragraph 2 of Article 6 (Income from Real Property), if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

Article 23--Capital

1. (a) Capital represented by real property referred to in Article 6 (Income from Real Property) and situated in a Contracting State may be taxed in that State.

(b) Capital represented by shares, rights, or an interest in a company the assets of which consist at least 50 percent of real property situated in a Contracting State, or derive at least 50 percent of their value, directly or indirectly, from real property situated in a Contracting State, may be taxed in that State.

(c) If and to the extent that the assets of a person other than an individual or a company consist of real property situated in a Contracting State, or derive their value, directly or indirectly, from real property situated in a Contracting State, capital represented by an interest in such person may be taxed in that State.

2. Capital of an individual represented by shares, rights, or an interest (other than shares, rights, or an interest referred to in subparagraph (b) or (c) of paragraph 1) forming part of a substantial interest in a company that is a resident of a Contracting State may be taxed in that State. An individual is considered to have a substantial interest if he or she owns, alone or with related persons, directly or indirectly, shares, rights, or interests the total of which gives right to at least 25 percent of the corporate earnings.

3. Capital represented by movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base that is available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services may be taxed in that other State.

4. Capital of an enterprise of a Contracting State that operates ships or aircraft in international traffic represented by such ships or aircraft and movable property pertaining to the operation of such ships or aircraft shall be taxable only in that State.

5. All other elements of capital of a resident of a Contracting State are taxable only in that State.

6. Notwithstanding the provisions of the preceding paragraphs of this Article, for the purposes of taxation with respect to the wealth tax referred to in subparagraph (b)(iv) of paragraph 1 of Article 2 (Taxes Covered) of an individual resident of France who is a citizen of the United States and not a French national, the assets situated outside of France that such a person owns on the first of January of each of the five years following the calendar year in which he becomes a resident of France shall be excluded from the base of assessment of the above-mentioned wealth tax relating to each of those five years. If such an individual loses the status of resident of France for a duration of at least three years and again becomes a resident of France, the assets situated outside of France that such a person owns on the first of January of each of the five years following the calendar year in which he again becomes a resident of France shall be excluded from the base of assessment of the tax relating to each of those five years.

Article 24--Relief from Double Taxation

1. (a) 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 or a resident of the United States as a credit against the United States income tax:

(i) the French income tax paid by or on behalf of such citizen or resident; and

(ii) in the case of a United States company owning at least 10 percent of the voting power of a company that is a resident of France and from which the United States company receives dividends, the French income tax paid by or on behalf of the distributing corporation with respect to the profits out of which the dividends are paid.

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

(i) the United States shall allow as a credit against the United States income tax the French income tax paid after the credit referred to in subparagraph (a)(iii) of paragraph 2. However, the credit so allowed against United States income tax shall not reduce that portion of the United States income tax that is creditable against French income tax in accordance with subparagraph (a)(iii) of paragraph 2;

(ii) income referred to in paragraph 2 and income that, but for the citizenship of the taxpayer, would be exempt from United States income tax under the Convention, shall be considered income from sources within France to the extent necessary to give effect to the provisions of subparagraph (b)(i). The provisions of this subparagraph (b)(ii) shall apply only to the extent that an item of income is included in gross income for purposes of determining French tax. No provision of this subparagraph (b) relating to source of income shall apply in determining credits against United States income tax for foreign taxes other than French income tax as defined in subparagraph (e); and

(c) In the case of an individual who is both a resident and citizen of the United States and a national of France, the provisions of paragraph 2 of Article 29 (Miscellaneous Provisions) shall apply to remuneration and pensions described in paragraph 1 or 2 of Article 19 (Public Remuneration), but such remuneration and pensions shall be treated by the United States as income from sources within France.

(d) If, for any taxable period, a partnership of which an individual member is a resident of France so elects, for United States tax purposes, 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. The amount of such income shall reduce (but not below zero) the amount of partnership earned income from sources outside the United States that 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. If the individual member of the partnership is both a resident of France and a citizen of 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.

(e) For the purposes of this Article, the term "French income tax" means the taxes referred to in subparagraph (b)(i) or (ii) of paragraph 1 of Article 2 (Taxes Covered), and

any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes.

2. In the case of France, double taxation shall be avoided in the following manner:

(a) Income arising in the United States that may be taxed or shall be taxable only in the United States in accordance with the provisions of this Convention shall be taken into account for the computation of the French tax where the beneficiary of such income is a resident of France and where such income is not exempted from company tax according to French domestic law. In that case, the United States tax shall not be deductible from such income, but the beneficiary shall be entitled to a tax credit against the French tax. Such credit shall be equal:

(i) in the case of income other than that referred to in subparagraphs (ii) and (iii), to the amount of French tax attributable to such income;

(ii) in the case of income referred to in Article 14 (Independent Personal Services), to the amount of French tax attributable to such income; however, in the case referred to in paragraph 4 of Article 14 (Independent Personal Services), such credit shall not give rise to an exemption that exceeds the limit specified in that paragraph;

(iii) in the case of income referred to in Article 10 (Dividends), Article 11 (Interest), Article 12 (Royalties), paragraph 1 of Article 13 (Capital Gains), Article 16 (Directors' Fees), and Article 17 (Artistes and Sportsmen), to the amount of tax paid in the United States in accordance with the provisions of the Convention; however, such credit shall not exceed the amount of French tax attributable to such income.

(b) In the case where the beneficial owner of the income arising in the United States is an individual who is both a resident of France and a citizen of the United States, the credit provided in paragraph 2 (a)(i) shall also be granted in the case of:

(i) income consisting of dividends paid by a company that is a resident of the United States, interest arising in the United States, as described in paragraph 5 of Article 11 (Interest), or royalties arising in the United States, as described in paragraph 6 of Article 12 (Royalties), that is derived and beneficially owned by such individual and that is paid by:

(aa) the United States or any political subdivision or local authority thereof; or

(bb) a person created or organized under the laws of a state of the United States or the District of Columbia, the principal class of shares of or interests in which is substantially and regularly traded on a recognized stock exchange as defined in subparagraph (e) of paragraph 6 of Article 30 (Limitation on Benefits of the Convention); or

(cc) a company that is a resident of the United States, provided that less than 10 percent of the outstanding shares of the voting power in such company was owned (directly or indirectly) by the resident of France at all times during the part of such company's taxable period preceding the date of payment of the income to the owner of the income and during the prior taxable period (if any) of such company, and provided that less than 50 percent of

such voting power was owned (either directly or indirectly) by residents of France during the same period; or

(dd) a resident of the United States, not more than 25 percent of the gross income of which for the prior taxable period (if any) consisted directly or indirectly of income derived from sources outside the United States;

(ii) capital gains derived from the alienation of capital assets generating income described in subparagraph (i); however, such alienation shall be taken into account for the determination of the threshold of taxation applicable in France to capital gains on movable property;

(iii) profits or gains derived from transactions on a public United States options or futures market;

(iv) income dealt with in subparagraph (a) of paragraph 1 of Article 18 (Pensions) to the extent attributable to services performed by the beneficiary of such income while his principal place of employment was in the United States;

(v) income that would be exempt from United States tax under Articles 20 (Teachers and Researchers) or 21 (Students and Trainees) if the individual were not a citizen of the United States; and

(vi) U.S. source alimony and annuities.

The provisions of this subparagraph (b) shall apply only if the citizen of the United States who is a resident of France demonstrates that he has complied with his United States income tax obligations, and subject to receipt by the French tax administration of such certification as may be prescribed by the competent authority of France, or upon request to the French tax administration for refund of tax withheld together with the presentation of any certification required by the competent authority of France.

(c) A resident of France who owns capital that may be taxed in the United States according to the provisions of paragraph 1, 2, or 3 of Article 23 (Capital) may also be taxed in France in respect of such capital. The French tax shall be computed by allowing a tax credit equal to the amount of tax paid in the United States on such capital. That tax credit shall not exceed the amount of the French tax attributable to such capital.

(d)(i) For purposes of this paragraph, the term "resident of France" includes a "societe de personnes," a "groupement d'interet economique" (economic interest group), or a "groupement europeen d'interet economique" (European economic interest group) that is constituted in France and has its place of effective management in France.

(ii) The term "amount of French tax attributable to such income," as used in subparagraph (a) means:

(aa) where the tax on such income is computed by applying a proportional rate, the amount of the net income concerned multiplied by the rate which actually applies to that income;

(bb) where the tax on such income is computed by applying a progressive scale, the amount of the net income concerned multiplied by the rate resulting from the ratio of the French income tax actually payable

on the total net income in accordance with French law to the amount of that total net income.

(iii) The term "amount of tax paid in the United States" as used in subparagraph (a) means the amount of the United States income tax effectively and definitively borne in respect of the items of income concerned, in accordance with the provisions of the Convention, by the beneficial owner thereof who is a resident of France. But this term shall not include the amount of tax that the United States may levy under the provisions of paragraph 2 of Article 29 (Miscellaneous Provisions).

(iv) The interpretation of subparagraphs (ii) and (iii) shall apply, by analogy, to the terms "amount of the French tax attributable to such capital" and "amount of tax paid in the United States," as used in subparagraph (c).

(e)(i) Where French domestic law allows companies that are residents of France to determine their taxable profits on a consolidation basis, including the profits or losses of subsidiaries that are residents of the United States or of permanent establishments situated in the United States, the provisions of the Convention shall not prevent the application of that law.

(ii) Where in accordance with its domestic law, France, in determining the taxable profits of residents, permits the deduction of the losses of subsidiaries that are residents of the United States or of permanent establishments situated in the United States and includes the profits of those subsidiaries or of those permanent establishments up to the amount of the losses so deducted, the provisions of the Convention shall not prevent the application of that law.

(iii) Nothing in the Convention shall prevent France from applying the provisions of Article 209B of its tax code (code general des impôts) or any substantially similar provisions which may amend or replace the provisions of that Article.

Article 25--Non-Discrimination

1. Individuals who are nationals of a Contracting State and residents of the other Contracting State shall not be subjected in that other State to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which individuals who are nationals and residents of that other State in the same circumstances are or may be subjected.

2. The taxation on a permanent establishment that an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents. The provisions of this paragraph shall not prevent the application by either Contracting State of the taxes described in paragraph 7 of Article 10 (Dividends).

3. (a) Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 6 of Article 11 (Interest), or paragraph 7 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

(b) Nothing in this Convention shall prevent the application of Article 212 of the French tax code (code general des impôts) as it may be amended from time to time without changing the general principle thereof, or of any substantially similar provisions which may be enacted in addition to or in substitution for that provision (including provisions substantially similar to those applicable in the other Contracting State), to the extent that such application is consistent with the principles of paragraph 1 of Article 9 (Associated Enterprises).

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision (in the case of the United States) or local authority thereof.

Article 26--Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national. The case must be presented within three years of the notification of the action resulting in taxation not in accordance with the provisions of this Convention.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. In particular, they may agree:

- (a) to the same attribution of profits to a resident of a Contracting State and its permanent establishment situated in the other Contracting State;
- (b) to the same allocation of income between a resident of a Contracting State and any associated enterprise described in paragraph 1 of Article 9 (Associated Enterprises);
- (c) to the same determination of the source of particular items of income;
- (d) concerning the matters described in subparagraphs (a), (b), and (c) of this paragraph with respect to past or future years; or
- (e) to increase the money amounts referred to in Articles 17 (Artistes and Sportsmen) and 21 (Students and Trainees) to reflect economic or monetary developments. They may also agree to eliminate double taxation in cases not provided for in the Convention.

5. [4] The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding

paragraphs. When it seems advisable for the purpose of reaching agreement, the competent authorities or their representatives may meet together for an oral exchange of opinions.

6. [5] If an agreement cannot be reached by the competent authorities pursuant to the previous paragraphs of this Article, the case may, if both competent authorities and the taxpayer agree, be submitted for arbitration, provided that the taxpayer agrees in writing to be bound by the decision of the arbitration board. The competent authorities may release to the arbitration board such information as is necessary for carrying out the arbitration procedure. The decision of the arbitration board shall be binding on the taxpayer and on both States with respect to that case. The procedures, including the composition of the board, shall be established between the Contracting States by notes to be exchanged through diplomatic channels after consultation between the competent authorities. The provisions of this paragraph shall not have effect until the date specified in the exchange of diplomatic notes.

Article 27--Exchange of Information

1. The competent authorities of the Contracting States shall exchange such information as is pertinent for carrying out the provisions of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is not contrary to this Convention. The exchange of information is not restricted by Article 1 (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;

(b) to supply particulars that are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(c) to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

3. The exchange of information shall be on request with reference to particular cases, or spontaneous, or on a routine basis. The competent authorities of the Contracting States shall agree on the list of information which shall be furnished on a routine basis.

4. (a) If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if its own taxation were involved, notwithstanding the fact that the other State may not, at that time, need such information for purposes of its own tax.

(b) If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall, if possible, provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts,

and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that [the] other State with respect to its own taxes.

(c) A Contracting State shall allow representatives of the other Contracting State to enter the first-mentioned State to interview taxpayers and look at and copy their books and records, but only after obtaining the consent of those taxpayers and the competent authority of the first-mentioned State (who may be present or represented, if desired), and only if the two Contracting States agree, in an exchange of diplomatic notes, to allow such inquiries on a reciprocal basis. Such inquiries shall not be considered audits for purposes of French domestic law.

5. Notwithstanding the provisions of Article 2 (Taxes Covered), all taxes imposed on behalf of a Contracting State shall be considered as taxes covered by the Convention for purposes of this Article.

Article 28--Assistance in Collection

1. The Contracting States undertake to lend assistance and support to each other in the collection of the taxes to which this Convention applies (together with interest, costs, and additions to the taxes and fines not being of a penal character) in cases where the taxes are definitively due according to the laws of the State making the application.

2. Revenue claims of each of the Contracting States which have been finally determined will be accepted for enforcement by the State to which application is made and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes.

3. The application will be accompanied by such documents as are required by the laws of the State making the application to establish that the taxes have been finally determined.

4. If the revenue claim has not been finally determined, the State to which application is made will take such measures of conservancy (including measures with respect to transfer of property of nonresident aliens) as are authorized by its laws for the enforcement of its own taxes.

5. The assistance provided for in this Article shall not be accorded with respect to citizens, companies, or other entities of the Contracting State to which application is made except in cases where the exemption from or reduction of tax or the payment of tax credits provided for in paragraph 4 of Article 10 (Dividends) granted under the Convention to such citizens, companies, or other entities has, according to mutual agreement between the competent authorities of the Contracting States, been enjoyed by persons not entitled to such benefits.

Article 29--Miscellaneous Provisions

1. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by

(a) the laws of:

(i) the United States;

(ii) France, in the case of a resident (within the meaning of Article 4 (Resident)) or citizen of the United States. However, notwithstanding the preceding sentence, the provisions of paragraph 5 of Article 6 (Income from Real Property), Article 19 (Public Remuneration), Article 20 (Teachers and Researchers), and Article 24 (Relief from Double

Taxation) shall apply, regardless of any exclusion, exemption, deduction, credit, or other allowance accorded by the laws of France; or

(b) by any other agreement between the Contracting States.

2. Notwithstanding any provision of the Convention except the provisions of paragraph 3, the United States may tax its residents, as determined under Article 4 (Resident), and its citizens as if the Convention had not come into effect. 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.

3. The provisions of paragraph 2 shall not affect:

(a) the benefits conferred under paragraph 2 of Article 9 (Associated Enterprises), under paragraph 1(b) of Article 18 (Pensions), and under Articles 24 (Relief From Double Taxation), 25 (Non-Discrimination), and 26 (Mutual Agreement Procedure); and

(b) the benefits conferred under Articles 19 (Public Remuneration), 20 (Teachers and Researchers), 21 (Students and Trainees), and 31 (Diplomatic and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, the United States.

4. Notwithstanding the provisions of Article 2 (Taxes Covered), any transaction in which an order for the purchase, sale, or exchange of stocks or securities originates in one Contracting State and is executed through a stock exchange in the other Contracting State shall be exempt in the first-mentioned State from stamp or like tax otherwise arising with respect to such transaction.

5. A resident of a Contracting State that maintains one or several abodes in 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 those abodes.

6. Nothing in this Convention shall affect the U.S. taxation of an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit under section 860G of the Internal Revenue Code, as it may be amended from time to time without changing the general principle thereof.

7. For purposes of the taxation by France of residents of France who are citizens of the United States:

(a) benefits other than capital gain received by reason of the exercise of options with respect to shares of companies resident in the United States shall be considered income when and to the extent that the exercise of the option or disposition of the stock gives rise to ordinary income for United States tax purposes;

(b) United States state and local income taxes on income from personal services and any other business income (except income that is exempt under subparagraph 2(a)(i) or (ii) of Article 24 (Relief from Double Taxation)) shall be allowed as business expenses.

8. Notwithstanding the provisions of subparagraph 1(b):

(a) Notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning whether a measure is within the scope of this Convention shall be considered only by the competent authorities of the

Contracting States, as defined in subparagraph 1(h) of Article 3 (General Definitions) of this Convention, and the procedures under this Convention exclusively shall apply to the dispute.

(b) Unless the competent authorities determine that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade. No national treatment or most-favored-nation obligation under any other agreement shall apply with respect to that measure.

(c) For the purpose of this paragraph, a "measure" is a law, regulation, rule, procedure, decision, administrative action, or any other form of measure.

Article 30--Limitation on Benefits of the Convention

1. A resident of a Contracting State that derives income from the other Contracting State shall be entitled in that other State to all of the benefits of this Convention only if such resident is one of the following:

(a) an individual;

(b) a Contracting State, a political subdivision (in the case of the United States) or local authority thereof, or an agency or instrumentality of that State, subdivision, or authority;

(c) a company meeting one of the following conditions:

(i) the principal class of its shares is listed on a recognized securities exchange located in either Contracting State and is substantially and regularly traded on one or more recognized securities exchanges;

(ii) more than 50 percent of the aggregate vote and value of its shares is owned, directly or indirectly, by any combination of companies that are resident in either Contracting State, the principal classes of the shares of which are listed and traded as described in subparagraph (c)(i), persons referred to in subparagraph (b), and companies of which more than 50 percent of the aggregate vote and value is owned by persons referred to in subparagraph (b);

(iii) (aa) at least 30 percent of the aggregate vote and value of its shares is owned, directly or indirectly, by any combination of companies that are resident in the first-mentioned Contracting State, the principal classes of the shares of which are listed and traded as described in subparagraph (c)(i), persons referred to in subparagraph (b), and companies of which more than 50 percent of the aggregate vote and value is owned by persons referred to in subparagraph (b); and

(bb) at least 70 percent of the aggregate vote and value of its shares is owned, directly or indirectly, by any combination of companies that are residents of either Contracting State or of one or more member states of the European Union, the principal classes of shares of which are listed and substantially and regularly traded on one or more recognized stock exchanges, persons referred to in subparagraph (b), companies of which more than 50 percent of the aggregate vote and value is owned by persons referred to in subparagraph (b), one or more member states of the European Union, political subdivisions or local authorities thereof, or

agencies or instrumentalities of those member states, subdivisions, or authorities, and companies of which more than 50 percent of the aggregate vote and value is owned by such member states, subdivisions, authorities, or agencies or instrumentalities;

(d) a person, if 50 percent or more of the beneficial interest in such person (or, in the case of a company, 50 percent or more of the vote and value of the company's shares) is not owned, directly or indirectly, by persons that are not qualified persons, and:

(i) less than 50 percent of the gross income of such person is used, directly or indirectly, to make deductible payments to persons that are not qualified persons; or

(ii) less than 70 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are not qualified persons and less than 30 percent of such gross income is used, directly or indirectly, to make deductible payments to persons that are neither qualified persons nor residents of member states of the European Union;

(e) a pension trust or an organization referred to in subparagraph (b)(ii) of paragraph 2 of Article 4 (Resident), provided that more than half of its beneficiaries, members, or participants, if any, are qualified persons; or

(f) an investment entity referred to in subparagraph (b)(iii) of paragraph 2 of Article 4 (Residence), provided that more than half of the shares, rights, or interests in such entity is owned by qualified persons.

2. (a) A resident of a Contracting State shall also be entitled to the benefits of the Convention with respect to income derived from the other Contracting State if:

(i) such resident is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless the activities are banking or insurance activities carried on by a bank or insurance company);

(ii) the income is connected with or incidental to the trade or business in the first-mentioned State; and

(iii) the trade or business is substantial in relation to the activity in the other State that generated the income.

(b) For purposes of subparagraph (a), whether the trade or business of the resident in the first-mentioned State is substantial in relation to the activity in the other State will be determined based on all of the facts and circumstances. In any case, however, the trade or business will be deemed substantial if, for the first preceding taxable period or for the average of the three preceding taxable periods, each of the following ratios equals at least 7.5 percent and the average of the ratios exceeds 10 percent:

(i) the ratio of the value of assets used or held for use in the conduct of the trade or business of the resident in the first-mentioned State to the value of assets used or held for use in the conduct of the activity in the other State;

(ii) the ratio of the gross income derived from the conduct of the trade or business of the resident in the first-mentioned State to the gross income derived from the conduct of the activity in the other State;

(iii) the ratio of the payroll expense of the trade or business of the resident in the first-mentioned State for services performed in that State to the payroll expense of the activity in the other State for services performed in that other State.

In determining the above ratios, assets, income, and payroll expense shall be taken into account only to the extent of the resident's direct or indirect ownership interest in the activity in the other State. If neither the resident nor any of its associated enterprises has an ownership interest in the activity in the other State, the resident's trade or business in the first-mentioned State shall be considered substantial in relation to such activity.

3. A resident of a Contracting State shall also be entitled to the benefits of this Convention if that resident functions as a headquarter company for a multinational corporate group.

4. A company resident in a Contracting State shall also be entitled to the benefits of the Convention in respect of income referred to in Articles 10 (Dividends), 11 (Interest), or 12 (Royalties) if:

- (a) more than 30 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by qualified persons resident in that State;
- (b) more than 70 percent of all such shares is owned, directly or indirectly, by any combination of one or more qualified persons and persons that are residents of member states of the European Union; and
- (c) such company meets the base reduction test described in subparagraphs (d)(i) and (ii) of paragraph 1.

5. Notwithstanding the provisions of paragraphs 1 through 4, where an enterprise of a Contracting State that is exempt from tax in that State on the profits of its permanent establishments which are not situated in that State derives income from the other Contracting State, and that income is attributable to a permanent establishment which that enterprise has in a third jurisdiction, the tax benefits that would otherwise apply under the other provisions of the Convention will not apply to any item of income on which the combined tax in the first-mentioned State and in the third jurisdiction is less than 60 percent of the tax that would be imposed in the first-mentioned State if the income were earned in that State by the enterprise and were not attributable to the permanent establishment in the third jurisdiction. Any dividends, interest, or royalties to which the provisions of this paragraph apply shall be subject to tax in the other State at a rate not exceeding 15 percent of the gross amount thereof. Any other income to which the provisions of this paragraph apply shall be subject to tax under the provisions of the domestic law of the other Contracting State, notwithstanding any other provision of the Convention. The provisions of this paragraph shall not apply if:

- (a) the income derived from the other Contracting State is in connection with or incidental to the active conduct of a trade or business carried on by the permanent establishment in the third jurisdiction (other than the business of making or managing investments unless these activities are banking or insurance activities carried on by a bank or insurance company); or
- (b) when France is the first-mentioned State, France taxes the profits of such permanent establishment according to the provisions of its domestic law referred to in subparagraph (e)(iii) of paragraph 2 of Article 24 (Relief from Double Taxation) or the United States taxes such profits according to the provisions of subpart F of part II of subchapter N of chapter 1 of subtitle A of the Internal Revenue Code, as it may be amended from time to time without changing the general principle thereof.

6. The following definitions shall apply for purposes of this Article:

- (a) The reference in subparagraphs (c)(ii) and (c)(iii) of paragraph 1 to shares that are owned "directly or indirectly" shall mean that all companies in the chain of ownership must be residents of a Contracting State or of a member state of the European Union, as defined in subparagraph (d) of paragraph 6.
- (b) The term "gross income," as used in subparagraph (d) of paragraph 1, means gross income for the first taxable period preceding the current taxable period, provided that the amount of gross income for the first taxable period preceding the current taxable period shall be deemed to be no less than the average of the annual amounts of gross income for the four taxable periods preceding the current taxable period.
- (c) The term "deductible payments" as used in subparagraph (d) of paragraph 1 includes payments for interest or royalties, but does not include payments at arm's length for the purchase or use of or the right to use tangible property in the ordinary course of business or remuneration at arm's length for services performed in the Contracting State in which the person making such payments is a resident. Types of payments may be added to, or eliminated from, the exceptions mentioned in the preceding definition of "deductible payments" by mutual agreement of the competent authorities.
- (d) The term "resident of a member state of the European Union," as used in paragraph 1, means a person that would be entitled to the benefits of a comprehensive income tax convention in force between any member state of the European Union and the Contracting State from which the benefits of this Convention are claimed, provided that if such convention does not contain a comprehensive Limitation on Benefits article (including provisions similar to those of subparagraphs (c) and (d) of paragraph 1 and paragraph 2 of this Article), the person would be entitled to the benefits of this Convention under the principles of paragraph 1 if such person were a resident of one of the Contracting States under Article 4 (Resident) of this Convention.
- (e) The term "recognized securities exchange" as used in paragraph 1 means:
- (i) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange for purposes of the U.S. Securities Exchange Act of 1934;
 - (ii) the French stock exchanges controlled by the "Commission des opérations de bourse," and the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Sydney, Tokyo, and Toronto;
 - (iii) any other stock exchanges agreed upon by the competent authorities of both Contracting States.
- (f) The term "qualified person" as used in paragraphs 1 and 4 means any person that is entitled to the benefits of the Convention under paragraph 1 or who is a citizen of the United States;
- (g) the term "engaged in the active conduct of a trade or business" as used in paragraph 2 applies to a person that is directly so engaged or is a partner in a partnership that is so engaged, or is so engaged through one or more associated enterprises (wherever resident);

(h) the term "headquarter company" as used in paragraph 3 means a person fulfilling the following conditions:

(i) it provides in the Contracting State of which it is a resident a substantial portion of the overall supervision and administration of a multinational corporate group, which may include, but cannot be principally, group financing;

(ii) the corporate group consists of companies that are resident in, and engaged in an active business in, at least five countries, and the business activities carried on in each of the five countries (or five groupings of countries) generate at least 10 percent of the gross income of the group;

(iii) the business activities carried on in any one country other than the Contracting State of which the headquarter company is a resident generate less than 50 percent of the gross income of the group;

(iv) no more than 25 percent of its gross income is derived from the other State;

(v) it has, and exercises, independent discretionary authority to carry out the functions referred to in subparagraph (i);

(vi) it is subject to the same income taxation rules in the Contracting State of which it is a resident as persons described in paragraph 2; and

(vii) the income derived in the other Contracting State either is derived in connection with, or is incidental to, the active business referred to in subparagraph (ii).

If the gross income requirements of subparagraph (ii), (iii), or (iv) of this paragraph are not fulfilled, they will be deemed to be fulfilled if the required ratios are met when calculated on the basis of the average gross income of the headquarters company and the average gross income of the group for the preceding four taxable periods.

7. A resident of a Contracting State that is not entitled to the benefits of the Convention under the provisions of the preceding paragraphs of this Article shall, nevertheless, be granted the benefits of the Convention if the competent authority of the other Contracting State determines, upon such person's request,

(a) that the establishment, acquisition, or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention, or

(b) that it would not be appropriate, having regard to the purpose of this Article, to deny the benefits of the Convention to such person.

The competent authority of the other Contracting State shall consult with the competent authority of the first-mentioned State before denying the benefits of the Convention under this paragraph.

8. The competent authorities of the Contracting States may consult together with a view to developing a commonly agreed application of the provisions of this Article.

Article 31--Diplomatic and Consular Officers

1. Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.
2. Notwithstanding the provisions of Article 4 (Resident), an individual who is a member of a diplomatic mission, consular post, or permanent mission of a Contracting State that is situated in the other Contracting State or in a third State shall be deemed for the purposes of the Convention to be a resident of the sending State if he is liable therein to the same obligations in relation to tax on his total income or capital as are residents of that State.
3. The Convention shall not apply to international organizations, to organs or officials thereof, or to persons who are members of a diplomatic mission, consular post, or permanent mission of a third State, who are present in a Contracting State and are not liable in either Contracting State to the same obligations in respect of taxes on income or on capital as are residents of that State.

Article 32--Provisions for Implementation

1. Notwithstanding the provisions of subparagraph 4(i) of Article 10 (Dividends) and of paragraph 8 of Article 30 (Limitation on Benefits of the Convention), the competent authorities of the Contracting States may prescribe rules and procedures, jointly or separately, to determine the mode of application of the provisions of this Convention.
2. The requirements to which a resident of a Contracting State may be subjected in order to obtain in the other Contracting State the tax reductions, exemptions, or other advantages provided for by the Convention shall, unless otherwise settled, jointly or separately, by the competent authorities, include the presentation of a form providing the nature and the amount or value of the income or capital concerned, the residence of the taxpayer, and other relevant information. If so agreed by the competent authorities, the form shall include such certification by the tax administration of the first-mentioned State as may be prescribed by them.

Article 33--Entry into Force

1. The Contracting States shall notify each other when their respective constitutional and statutory requirements for the entry into force of this Convention have been satisfied. The Convention shall enter into force on the date of receipt of the later of such notifications.
2. The provisions of the Convention shall have effect:
 - (a) in respect of taxes withheld at source on dividends, interest, and royalties and the U.S. excise tax on insurance premiums paid to foreign insurers, for amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;
 - (b) in respect of other taxes on income, for taxable periods beginning on or after the first day of January of the year following the year in which the Convention enters into force; and
 - (c) in respect of taxes not mentioned in subparagraph (a) or (b), for taxes on taxable events occurring on or after the first day of January of the year following the year in which the Convention enters into force.
3. Notwithstanding the provisions of paragraph 2,

(a) the provisions of subparagraph (e) of paragraph 4 of Article 10 (Dividends) and of Article 12 (Royalties) shall have effect for dividends and royalties paid or credited on or after the first day of January 1991;

(b) The provisions of Article 26 shall apply in respect of cases presented to the competent authorities on or after the date of entry into force of the Convention.

4. The Convention Between the United States of America and the French Republic with Respect to Taxes on Income and Property, Signed on July 28, 1967 and Amended by Protocols of October 12, 1970, November 24, 1978, January 17, 1984 and June 16, 1988 and the exchanges of letters attached thereto shall cease to have effect from the date on which the provisions of this Convention become effective in accordance with the provisions of this Article.

Article 34--Termination

This Convention shall remain in force indefinitely. However, either Contracting State may terminate the Convention by giving notice of termination through diplomatic channels at least six months before the end of any calendar year after the expiration of a period of five years from the date on which the Convention enters into force. In such event, the Convention shall cease to have effect:

(a) in respect of taxes withheld at source on dividends, interest, and royalties and the U.S. excise tax on insurance premiums paid to foreign insurers, for amounts paid or credited on or after the first day of January next following the expiration of the six-month period;

(b) in respect of other taxes on income, for taxable periods beginning on or after the first day of January next following the expiration of the six-month period; and

(c) in respect of taxes not described in subparagraph (a) or (b), for taxes on taxable events occurring on or after the first day of January of the year following the expiration of the six-month period.

DONE at Paris, this thirty-first day of August, 1994, in duplicate, in the English and French languages, both texts being equally authentic.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

FOR THE GOVERNMENT OF THE FRENCH REPUBLIC:

APPENDIX B

CODE GENERAL DES IMPOTS, CGI.

Article 57

(Loi n° 81-1160 du 30 décembre 1981 art. 90 II finances pour 1982 Journal Officiel du 31 décembre 1981 date d'entrée en vigueur 1er janvier 1982)

(Loi n° 96-314 du 12 avril 1996 art. 39 II, V Journal Officiel du 13 avril 1996)

Pour l'établissement de l'impôt sur le revenu dû par les entreprises qui sont sous la dépendance ou qui possèdent le contrôle d'entreprises situées hors de France, les bénéfices indirectement transférés à ces dernières, soit par voie de majoration ou de diminution des prix d'achat ou de vente, soit par tout autre moyen, sont incorporés aux résultats accusés par les comptabilités. Il est procédé de même à l'égard des entreprises qui sont sous la dépendance d'une entreprise ou d'un groupe possédant également le contrôle d'entreprises situées hors de France.

La condition de dépendance ou de contrôle n'est pas exigée lorsque le transfert s'effectue avec des entreprises établies dans un Etat étranger ou dans un territoire situé hors de France dont le régime fiscal est privilégié au sens du deuxième alinéa de l'article 238 A.

((En cas de défaut de réponse à la demande faite en application de l'article L. 13 B du livre des procédures fiscales, les bases d'imposition concernées par la demande sont évaluées par l'administration à partir des éléments dont elle dispose et en suivant la procédure contradictoire définie aux articles L. 57 à L. 61 du même livre)) (M).

A défaut d'éléments précis pour opérer les redressements prévus aux premier, deuxième et troisième alinéas, les produits imposables sont déterminés par comparaison avec ceux des entreprises similaires exploitées normalement.

(M) Modification de la loi 96-314. Dispositions applicables aux contrôles engagés à compter de la date d'entrée en vigueur de la loi.