The First US Tax Treaty and Its Influence

In 1945, the US negotiated a tax treaty with the UK.[1] This treaty was based on the London model, which was the last contribution of the League of Nations to international tax. Since it was a treaty between the two most important economies in the world, it precipitated the post-war rise in tax treaty negotiations. It also was similar to the first OECD model of 1963. In general, with a few exceptions (citizenship-based taxation, residence of corporations, limitation on benefits) the US models of 1981, 1996, 2006 and 2016 closely resemble the OECD model. This is not surprising given the close US involvement in OECD from its inception.

This paper will however focus on another US treaty, the first one, concluded with France in 1932 and ratified in 1935.[2] This treaty is interesting because it follows the League of Nations model of 1928 but with significant differences. It is also a treaty between a global jurisdiction and (at the time) a purely territorial one. This meant that while reductions in French taxes benefited the US fisc because they resulted in lower foreign tax credits (but the overall tax level was the same), French investors into the US could derive some types of income (e.g., royalties) without any tax being imposed by either country. This may also explain why the treaty was more limited in scope than the League of Nations model.

Mitchell Carroll, who was active in negotiating the treaty, explains the circumstances as follows:

> A foreign corporation with a branch in France had been subjected to the to the tax that was withheld from dividends paid by French companies, but on the same proportion of dividends distributed at its head office abroad as its assets in France bore to total assets. In the 1920's the Boston Blacking Company of Massachusetts, in order to obviate the accounting adjustments necessitated by devaluations of the franc, had exchanged the assets of its branch in Paris for registered shares in a newly formed French company. This tax was presumably no longer due except when the French company distributed dividends. Nevertheless, the Bureau de l'Enregistrement, which administered the levy, served a 'sommation' on the American corporation to pay the tax. The company contested the assessment but the fisc was upheld by the Tribunal de la Seine.
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> The United States company appealed to the Court of Cassation. Encouraged by the decision of the lower Court, the Bureau enquired into the relations between various French companies and their respective foreign parent corporations, which were for the most part in the United Kingdom, the Netherlands, Belgium, Germany, Switzerland or in the United States. Claims were made against a number of our largest corporations. The assessment against one of them was based on the assertion that the French subsidiary was 'its emanation pure and simple'. Another company objected strenuously, and in order to establish a basis for bargaining, the fisc obtained from Moody's the figures of its distributions over the previous 30 years and computed thereon the tax and penalties. The total of the claims was enormous. The American Embassy in Paris forwarded protests to the Department of State' in Washington.
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> When former Senator Walter Evans Edge was leaving Washington in the autumn of 1929 to serve as Ambassador to France, an official in the State Department asked the writer to brief him on the situation. Early in 1930 the claims were mounting so high and the protests were becoming so bitter that Ambassador Edge cabled to the Department of State to send 'Carroll or other officials' to Paris in order to endeavour to persuade the French officials to desist.
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> At initial conferences in the Palais du Louvre, in May 1930, the Minister of the Budget, Mr. Germain Martin and French officials refused to settle the matter unilaterally. They insisted on negotiating a bilateral treaty with reciprocal concessions, which would set a precedent to invoke vis h vis other interested governments.
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> Negotiations were suspended in September, 1930, because of the French request for a reduction of our

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1 US-UK Tax Treaty (1945).

2 US-France Treaty (1932). The only other pre-1945 US tax treaty was with Canada (1942). *See* Mitchell B. Carroll, *Evolution of U.S. Treaties to Avoid Double Taxation of Income – Part II*, 3 Int'l L. 12 (1969).

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> custom duties on wines. After a change in the French Cabinet, the Treaty was signed on April 27, 1932. The United States Senate gave its advice and consent and the President promptly ratified on July 25, 1932; but France delayed, only ratifying the treaty in 1935.[3]

The treaty contains ten articles and a protocol. In what follows, I will compare these to the current OECD model to show what was included and what was missing.

Articles 1–4 of the OECD model are missing, but the protocol defines the taxes that are covered (like Article 2 of the OECD model). The protocol also contains a 'saving clause' limited to deductions, credits, and exemptions under the domestic law of either state. This is important because it meant that the French territorial system applies even if the treaty prevents source taxation. For example, a French enterprise deriving active income from the US without a PE would not be taxed by either state.

The protocol also defines PE in a similar manner to Article 5 of the OECD model, including dependent agents and excluding independent agents. The protocol defines enterprise of a contracting states in a way similar to Article 3 of the OECD model. Finally, the protocol defines the geographic scope of the treaty like Article 3, excluding territories and colonies.

There is no limitation of the treaty to residents (like Article 1 of the OECD model) and therefore also no definition of resident (like Article 4). Presumably that means that treaty shopping was potentially unlimited.

Article 1 is about taxation of business income, like Article 7 of the OECD model. It limits taxation by the source state to profits allocable to a permanent establishment in the other state. Purchasing is explicitly excluded from the scope of a PE, like in Article 5 of the OECD model.

Article 2 defines the obligations of a PE of either country to file tax returns, which is not found in the OECD model but follows from the right of treaty countries to tax PEs.

Article 3 prevents source taxation of aircraft (like Article 8 of the OECD model), but not shipping, which is remarkable given that shipping was much more common than air travel in 1932.

Article 4 is the most important innovation of the treaty. It states that:

> When an American enterprise, by reason of its participation in the management or capital of a French enterprise, makes or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with a third enterprise, any profits which should normally have appeared in the balance sheet of the French enterprise, but which have been, in this manner, diverted to the American enterprise, are, subject to the measures of appeal applicable in the case of the tax on industrial and commercial profits, incorporated in the taxable profits of the French enterprise.
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> The same principle applies mutatis mutandis in the event that profits are diverted from an American enterprise to a French enterprise.

As far as I know this is the first appearance of the arm`s length standard (ALS) in a tax treaty. It precedes the US regulation embodying the ALS (1935) and the studies by Mitchell Carroll for the League of Nations that led to the inclusion of what is now Article 9 in the model.[4]

This was a major innovation, and in my mind a highly problematic one, because it prevented the League from adopting formulary apportionment (FA) as suggested by the four economists in 1923 (method three of the 1923 report). Carrol was familiar with FA as practiced by US states but explicitly rejected it.

The ALS benefited both states even under the French territorial system, and it was aimed to prevent double source-source taxation. But even in 1932 it is doubtful that comparables could be found, and the effect was a significant potential for double non-taxation and endless controversies compared with FA. There was already litigation on this subject in the US and it would just increase over time.[5] In my opinion, the inclusion of the ALS in the League and OECD models was mistaken from the start, and it was only in 2021 that the OECD began to rectify this mistake.

Article 5 addresses taxation of securities attributable to a PE, and it provides for a lower rate of tax on dividends or interest deemed to be distributed by the PE (set at 75% of the normal French rate, based on the normal pattern of distribution of dividends). This article only applies to US corporations with French PEs, not to French corporations with US PEs, because France would not tax this income. This is an interesting early example of a non-reciprocal treaty provision between countries with fundamentally

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3 Carroll, *supra* n. 2.

4 *See* Art. 45–1(c) of Reg. 86 (1935) (Revenue Act of 1934). The entire regulation is quoted in *Essex Broadcasters, Inc. v. Commissioner*, 2 T.C. 523, 528 (1943). Before that it was unclear on what basis the IRS could reallocate income between related corporations, as it was allowed to do since 1928. Revenue Act of 1928, Ch. 852, s. 45, 45 Stat. 806 (1928) (mostly identical to the first sentence of current s. 482). Before 1928, the IRS could require consolidation of foreign corporations with their US parents.

5 *See* e.g., *Asiatic Petroleum Co. v. Commissioner, 31 B.T.A. 1152, 1159 (1935)* (stating that a sale was not 'arm's length' but not focusing on this issue); aff'd, *79 F.2d 234.* For cases immediately after the adoption of the ALS *see G.U.R. Co. v. Commissioner, 41 B.T.A. 223 (1940)* (sale of stock at seven times its market value not arm's length); aff'd, *117 F.2d 187, National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943)*; cert. denied *320 U.S. 794.* This leading case for the application of s. 45 to tax-free transfers to corporations, surveys the history of s. 45 but does not mention the ALS.

different tax regimes. The later adoption of mandatory reciprocity in the OECD model was from this perspective a mistake. It is also similar to the current US branch profits tax (1986). As Carroll explains, this article addressed the issue that was the motivation for the treaty.[6]

Article 6 provides for full taxation on dividends and interest paid by a French subsidiary to a US parent. This article is also not reciprocal, because France would not tax dividends and interest paid by a US subsidiary to a French parent.

Article 7 provides for an exemption for wages paid by a contracting state to its citizens located in the other state. In practice this would only limit French taxation of US citizens in France. This is like the current protection of diplomats under Article 19 of the OECD model.

Article 8 provides an exemption for war pensions, like Article 18 of the OECD model. Article 9 provides for a similar exemption for private pensions and annuities.

Importantly, Article 9 provides for exemption from source taxation of 'Amounts paid as consideration for the right to use patents, secret processes and formulas, trademarks and other analogous rights' and 'Income received as copyright royalties'. While this provision is reciprocal, in practice it would mean US taxation of royalties derived from France, but double non-taxation of royalties derived from the US. It is like Article 12 of the OECD model.

Finally, Article 10 provides for entry into effect upon ratification, like Article 31 of the OECD model.

Overall, the treaty contains provisions similar to Articles 2,3, 5, 7, 8, 9, 10, 11, 12, 14, 15, 18, 19 and 31 of the OECD model. It does not contain any provisions like Articles 1, 4, 6, 13, 23, 24, 25 or 26. Presumably, in those cases the domestic laws would apply, e.g., to provide a foreign tax credit in the US and an exemption in France. The treaty also does not limit source taxation of dividends, interest, rents, and capital gains of individuals. The focus is on taxation of corporations (including PEs) and on royalties. This probably reflects the dominance of FDI and the relative unimportance of portfolio investment.

Overall, the treaty reflects the 1923 compromise (the benefits principle) of taxing active income at source (subject to the PE and for the first time the ALS lsimits) and passive income at residence. But unlike the 1923 report it allows for double non-taxation, because it reflects the French exemption system. The French and other territorial countries rejected the 1923 report because it did not allow for exemption as a method to alleviate double taxation. The treaty therefore benefited the US fisc by reducing foreign tax credits for dividends, interest, and royalties, but in the case of France it mostly benefited French investors.

Despite its limitations, the 1932 US-France treaty covered the most important areas to both countries, and it proved that a treaty can be negotiated between a global and a territorial country in a way the benefited both. It was thus an important precedent for the post war treaties between capital exporting countries that tended to be global and capital importing countries that tended to be territorial. But its enduring global importance derives from the first adoption of the ALS, with fateful results that are felt to this day (*see* Pillar 1 Amount B and the endless transfer pricing litigation).[7]

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6 Carroll, *supra* n. 2.

7 *See* generally Reuven 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 (1995).