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August 27, 2007

Via Courier
Benedetta A. Kissel, Esq.
Deputy International Tax Counsel (Strategic Programs)
U.S. Department of the Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: U.S.-France Income Tax Treaty Issue

Dear Ms. Kissel:

We write on behalf of the Association of Global Custodians ("Association") to request the assistance of your office in resolving an issue that has arisen under the U.S. income tax treaty with France, resulting in what we believe is an improper denial of treaty benefits.

The issue is whether otherwise available treaty benefits must be allowed for French source income to the extent that it is derived by U.S. residents through a U.S. trust, partnership, or other entity of a type specified by paragraph (2)(b)(iv) of Article 4 (Resident) of the treaty. Such income may be derived, for example, through (i) a U.S. limited liability company that has elected to be treated as a partnership for U.S. tax purposes, (ii) a U.S. common trust fund, or (iii) another type of U.S. entity treated as a partnership or a simple trust for U.S. tax purposes. In each case, the income for which treaty benefits are sought is treated for U.S. tax purposes as the income of a U.S. Regulated Investment Company (RIC) or of another person or persons that qualify as U.S. residents for purposes of the treaty. We believe that the treaty explicitly confirms that benefits are to be provided in such cases, but French tax authorities are taking a contrary position.

We first became aware of this issue when a private letter ruling was issued in 2004 by the Direction Générale Des Impôts (General Tax Division) of the Direction de la Législation Fiscale (Department of Tax Legislation or "DLF") to a client of a member bank of the Association. The ruling denied treaty benefits for income received by a U.S. RIC through a U.S. master fund, which was a simple trust for U.S. tax purposes. As

explained below, we believe that the 2004 ruling misinterpreted the provisions of the 1995 treaty then in effect.

The treaty has since been amended by a protocol signed in December 2004, which further clarified the treatment of income derived by U.S. residents through U.S. partnerships, trusts, and other entities specified in Article 4(2)(b). However, the DLF has indicated that, even under the treaty as amended by the 2004 protocol, it will continue to deny treaty benefits in such cases. We believe that this position is inconsistent with the requirements of the current treaty as well as the prior treaty. We understand that the U.S. Competent Authority's office has attempted to resolve this issue but that French officials have expressed the view that the treaty would have to be renegotiated to allow benefits in such cases.

The DLF Interpretation

In the 2004 ruling, the DLF noted that Article 4(2)(b)(iv) of the treaty defines resident of a Contracting State to include trusts not referred to in subparagraphs (ii) (pension trusts) and (iii) (REITs and certain other investment trusts), but only with respect to income they derive that is "subject to tax" in the United States as the income of a resident, either at the level of the trusts or at that of their beneficiaries. The ruling acknowledged that the beneficiaries were residents of the United States within the meaning of Article 4(2)(b)(iii) of the treaty, but argued that they were not taxed in the United States on the income they derived through the master fund. The ruling concluded that, since there is no U.S. tax imposed on the French source income, either at the level of the master fund or at the level of its beneficiaries, the provisions of Article 4(2)(b)(iv) do not apply to the master fund. The master fund, therefore, cannot be considered a resident of the United States under Article 4(2)(b)(iv) with respect to the income derived by those beneficiaries, according to the ruling.

As noted above, French tax authorities have indicated informally that their position regarding RICs investing in France in this manner remains unchanged notwithstanding the 2004 protocol amendments to the treaty. They also have denied treaty benefits to U.S. residents investing through a U.S. common trust fund or through a U.S. limited liability company that has elected to be treated as a partnership for U.S. tax purposes.

The Association's View

We respectfully submit that the DLF interpretation of the treaty is erroneous, both under the treaty as it applied when the 2004 ruling was issued and following its amendment by the 2004 protocol.

The first issue with the 2004 ruling was that it interpreted the phrase "subject to tax," as then used in Article 4(2)(b)(iv) of the treaty, as requiring the *actual payment* of tax. This is not, however, what the "subject to tax" concept means in the treaty context. As you know, U.S. treaties have long used the term "subject to tax" in the same sense as the OECD-favored term "liable to tax." The OECD Commentary on Article 4 confirms that the "liable to tax" requirement applies solely for purposes of determining whether an entity or other person is a resident of a contracting state for treaty purposes. It, therefore, requires only that the person in question be subject to the tax laws of the country as a resident, rather than on a more limited basis. The liable to tax/subject to tax provision does not require that the tax laws impose tax on the person, or that the person actually pay tax. Therefore, for example, the OECD Commentary notes that entities such as pension funds, charities, and other organizations generally are considered subject to tax even if they are statutorily exempted from tax.

We believe that the subject to tax issue was a red herring even at the time of the 2004 ruling, because Article 4(2)(b)(iv) takes into account tax treatment at the beneficiary level as well as the trust level. The income in question was derived by a U.S. RIC, and Article 4(2)(b)(iii) of the treaty provided (and continues to provide) that all U.S. RICs automatically qualify as residents of the United States, notwithstanding their general exemption from tax under U.S. laws. It was, therefore, clear in any event that the treaty did not require actual taxation of the income in this situation. The same was true for French source income derived by any U.S. resident through a U.S. partnership, trust, or other entity of a type specified in Article 4(2)(b)(iv).

Even if the rationale of the DLF 2004 ruling were correct, it cannot appropriately be applied to deny benefits under the current treaty. The "subject to tax" language relied upon by the ruling was modified by the 2004 protocol. The relevant text under Article 4(2)(b) of the current treaty reads as follows:

> "iv) a partnership or similar pass-through entity, an estate, and a trust (other than one referred to in subparagraph (ii) or (iii) above), whether or not organized or managed in one of the Contracting States, but only to the extent that the income derived by such partnership, similar entity, estate or trust is treated for taxation purposes in that 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...;"
>
> v) a partnership or similar pass-through entity, an estate, and a trust (other than one referred to in subparagraph (ii) or (iii) above), which is organized in the United States, shall be treated as a resident of the United States to the extent provided in subparagraph (iv) above,..."

As under the prior treaty, a U.S. RIC is automatically treated as a resident of the United States under Article 4(2)(b)(iii). Income derived by a U.S. RIC through a U.S. trust (other than a trust referred to in subparagraph (ii) or (iii)) is, consequently, always treated for U.S. taxation purposes as the income of a U.S. resident. Income derived by a U.S. RIC through such a trust, therefore, must be treated as the income of a U.S. resident. The same holds for income derived by other U.S. residents through a U.S. partnership, trust, or other entity covered by Article 4(2)(b)(iv). The treaty provides similar benefits for income derived through non-U.S. entities, subject to certain conditions, but French tax authorities are denying benefits even in cases involving U.S. entities.

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We respectfully submit that the correct interpretation of the treaty is clear. We would appreciate your assistance in clarifying this matter with the French tax authorities

so that U.S. RICs and other U.S. residents investing in France can receive the benefits of the treaty and, if required, confirming this in the protocol currently under negotiation.

If you have questions or require additional information, please contact Doug Shepherd at 617.382.1663 or me.

Sincerely,

Carol A. Dunahoo
Baker & McKenzie LLP
Counsel to the Association