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Eshel v. Commissioner: The IRS Concedes Defeat in FTC Case

by Robert Goulder

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The first boss I had at a law firm warned me about "principle" cases. You know the type. Those rare lawsuits where pragmatism would convince most people that their claim, though meritorious, isn't worth the hassle of protracted litigation — but the client chooses to fight on regardless. They do so because have an overarching point to prove. They're on a mission.

We don't see a lot of principle cases in the tax context. I suspect that's because there are plenty of valid reasons for taxpayers to fold their hand, even when thoroughly convinced justice is on their side. The opposition may be too big and powerful, the odds of success too slight. The anticipated payoff, should they win, may be of negligible economic value. Why incur hefty legal fees and court costs on such matters?

You know you're faced with a principle case when a client doesn't care how much time or money it takes to prove he's right. Occasionally faith in a client's noble purpose is transposed to counsel. Think Atticus Finch in *To Kill a Mockingbird*. The older I get, the more I admire Harper Lee's novel — and the more I appreciate principle cases.

Our latest example involves a joint status report released June 13 by the U.S. Tax Court in connection with *Eshel v. Commissioner*, 831 F.3d 512 (D.C. Cir. 2016). The issue concerns eligibility for a foreign tax credit under the France-U.S. social security agreement. The dollar amounts are paltry compared with the corporate matters typically discussed in these pages. But the case gives us plenty of meat to chew on regarding treaty interpretations and the FTC rules.[1] It also presents another opportunity to bash the U.S. tax code's flawed adherence to citizenship-based taxation, while the rest of the world is operating under residence-based taxation regimes.[2]

Facing a mountain of IRS intransigence, the taxpayers in *Eshel* could have easily given up their crusade years ago. It would have been the path of least resistance, but they refused to cave. In the end, they persevered. We suspect a wave of refund claims will follow, now that the IRS has formally revised its position on creditability. This column examines the details and offers a word of gratitude to Monsieur and Madame Eshel. *Chapeau!*

It's worth noting that the Eshels' attorney — Stuart Horwich — took on the case pro bono, forfeiting more than $300,000 in fees (in excess of 500 hours) because he believed the IRS's position was fundamentally flawed and desperately needed to be changed for the good of all similarly situated taxpayers.

Background

Our taxpayers are Linda and Ory Eshel, a married couple and dual citizens of France and the United States. They lived in France for much of their adult lives, including the tax years in question: 2008 and 2009. During that time, Ory Eshel had a job with a local company, which caused him to pay various French taxes related to his salary. These included income taxes, unemployment taxes, and social security taxes.

Eshel was also liable for U.S. income tax on his French salary, subject to an FTC. That's because the United States taxes individuals on the basis of their citizenship. If territoriality is good enough for behemoth multinationals that make billions in foreign profits, you'd think territoriality would

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[1] For prior coverage, see Annagabriella Colon, "U.S., France Settle on Social Security Agreement Interpretation," *Tax Notes Int'l*, June 24, 2019, p. 1348; and Alexander Lewis, "Appeals Court Overturns Decision on Social Security Agreement," *Tax Notes Int'l*, Aug. 15, 2016, p. 603.

[2] For related analysis, see Robert Goulder, "Residence-Based Taxation: The Other Territoriality," *Tax Notes Int'l*, Oct. 29, 2018, p. 561.

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also be suitable for taxpayers with a pulse. But you'd be wrong.

The United States and Eritrea are the only countries that use citizenship-based taxation. Eritrea does so to reach its diaspora, forcing them to help finance the country's military conflict with neighboring Ethiopia. As that conflict is now over, Eritrea might revert to residence-based taxation treatment. Such a move would leave the United States as the lone holdout, stubbornly clinging to citizenship-based taxation for reasons that aren't necessarily clear. We sometimes hear it said that citizenship-based taxation can be rationalized as a means of forcing expats to help pay for the consular services they receive from U.S. embassies around the world. That argument is hogwash. But I digress.

Among the French taxes that the Eshels paid were the Contribution Sociale Généralisée (CSG) and the Contribution Pour le Remboursement de la dette Sociale (CRDS). On their U.S. federal income tax returns, the Eshels claimed FTCs for both the income taxes paid to the French government and their CSG and CRDS payments. The CSG and CRDS credits drew IRS scrutiny; combined, they totaled $19,061 for 2008 and $32,672 for 2009. The Eshels did not claim FTCs for the other social security and unemployment taxes they paid to the French government.

The basic assumption behind the U.S. Social Security system is that members of the current workforce pay taxes to support current beneficiaries (retirees and the disabled), anticipating that they themselves will eventually become beneficiaries and be supported by future generations of workers. Things get tricky when people spend a portion of their career working in a foreign country. The underlying assumption is challenged because it generally can't be known where cross-border workers will eventually retire and expect to draw Social Security benefits; and whether the future receipt of those benefits will be taxable if the person retires in a different place from where the work was performed.

Governments enter totalization agreements to sort out the respective taxing rights for these situations. Totalization agreements can permit foreign workers to claim limited retirement or disability benefits based on how long they contributed to the host country's social security system, relative to the time they contributed to their home country's social security system. In this manner, totalization agreements try to avoid situations in which a worker fails to qualify as a beneficiary under either country's system by virtue of their working overseas.

As an example, consider a hypothetical worker who retired after 37 years in the workforce. Let's assume she spent 30 of those years working in Paris, paying into the French social security system, and the remaining seven years working in New York and paying into the U.S. Social Security system. Without a totalization agreement, the worker could be denied U.S. Social Security benefits and receive diminished pension benefits in France. With a totalization agreement, however, she could receive a fractional share of benefits from both countries, in proportion to the years worked. In other words, she would receive 7/37th of standard U.S. Social Security benefits, coupled with 30/37th of the normal French social security pension.[3]

Totalization agreements can also exempt workers from their home country's social security taxes when they reside overseas and work for a foreign employer. This was the case with Eshel, who was not obligated to pay U.S. Social Security taxes during the years in question. This represents a limited form of territoriality. It makes up for the fact there's no FTC available for social security taxes, as there is for income taxes.[4] (Note that totalization agreements are distinct from bilateral income tax treaties.) The only way to eliminate double taxation, in this context, is through an exemption rather than a credit mechanism.

Alternately, when the overseas work is expected to be of a short duration (less than five years), a totalization agreement may assign social security taxing rights exclusively to the worker's home country, avoiding the need for fractionally apportioned benefits. This is known as the "detached" worker scenario. It can be

[3]This example is drawn from the petitioners' appellate brief before the D.C. Circuit. *See also Georgiou v. Apfel*, 50 F. Supp. 2d 913, 197 (E.D. Mo. 1999).

[4]The disallowance of FTCs for social security taxes paid to foreign governments is independent of the provisions of any U.S. tax treaty. Section 317(b)(4) of the Social Security Amendments of 1977 (P.L. 95-216). The foregoing legislation also resulted in correlative adjustments to code sections 1401, 3101, and 3111.

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advantageous to the worker because it maximizes his country retirement benefits. It produces the odd situation where a worker pays social security taxes exclusively in his home country, while paying income taxes primarily in the host country. (The home country income tax burden would be relieved by application of the FTC.) This awkwardly pairs an exemption for one type of labor tax with a credit for another category of labor tax — but it does address double taxation, which is the point.

In the United States, Congress long ago decided to keep its distance from totalization agreements. They are the exclusive domain of the executive branch.[5] As such, totalization agreements do not require Senate ratification, like tax information exchange agreements or intergovernmental agreements under the Foreign Account Tax Compliance Act regime. The United States has 24 totalization agreements in place.

France and the United States executed a totalization agreement in 1987 (hereinafter, the SSA agreement), which entered into force July 1, 1988. Neither the CSG nor the CRDS existed at the time. The CSG was enacted in 1990, and the CRDS came along a few years later, in 1996. As such, they are not listed among the eight categories of taxes covered by article 2(1) of the SSA agreement. Article 2(3) extends the coverage to future legislation, as follows:

> This Agreement shall also apply to legislation which amends or supplements the laws specified in paragraph 1; however, it shall apply to future legislation of a Contracting State which creates new categories of beneficiaries only if the Competent Authority of that Contracting State does not notify the Competent Authority of the other Contracting State in writing within three months of the date of the official publication of the new legislation that no such extension of Agreement is intended.

The IRS and Eshel agreed that neither the CSG nor the CRDS created a new class of beneficiaries for purposes of France's social security system. The measures fund spending without creating a resulting entitlement or "period of coverage." Those who pay these taxes aren't buying future pension benefits.

The sole question before the court was whether those two French tax regimes "amend or supplement" any of the French social security taxes listed in article 2(1). If so, Eshel's payments for 2008 and 2009 are not creditable for U.S. income tax purposes. Otherwise, they are presumptively creditable like any other foreign income tax. In other words, the U.S. tax treatment hinges on an interpretation of French tax legislation.

The Tip of the Iceberg

What's the best way to determine whether the CSG and CRDS are closer to income taxes or social security taxes? The tax base is a good place to start.

We naturally think of social security taxes as being applied to labor income, but not capital income. The CSG applies to both. In addition to wages and salaries, the base includes interest, dividends, capital gains, rents, royalties, and gambling winnings. The base was expanded in 2012 to include gains from the sale of real estate by nonresidents. As stated in the petitioners' brief, "The scope of this tax is significant; the Taxpayers are not aware of a single instance where a social security tax applies to unearned as well as earned income, including unearned income of a nonresident."[6] The base of the CRDS tracks that of the CSG.

Are the CSG and CRDS collected by the same revenue body that normally collects social security taxes? Yes, partly. The taxes are collected in different ways depending on the source of income. For earned income, they are collected through Unions de Recouvrement des Cotisations de Sécurité Sociale et d'Allocations Familiales (URSSAF), which also collects French social security taxes. As applied to investment income, the taxes are collected by withholding at source or by personal tax returns (in the case of foreign-source investment income).

[5] The delegation of authority to the executive branch is codified at section 233 of the Social Security Act (42 U.S.C. section 433(a)).

[6] Petitioner's brief, *supra* note 3, at 15.

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Are receipts from the CSG and CRDS fed into the general coffers, as with the income taxes, or are they earmarked for social programs? As it turns out, receipts from the CSG cover a handful of intended uses that partially overlap with the enumerated taxes in the SSA agreement. These include the national family allowance fund, compulsory healthcare schemes, and a solidarity fund for the elderly. Receipts from the CRDS are used to retire public debt previously run up by spending on social programs.

Presumably the views of the French government should hold some weight as to the nature of these French taxes. Instead, the U.S. Tax Court generally favored the views of U.S. officials when it heard the case in 2014.[7] The court noted a statement by Vance Teel, the acting associate commissioner for the Office of International Programs in the U.S. Social Security Administration, concluding that to the best of his knowledge and belief CSG and CRDS were covered by the SSA agreement — and therefore were not creditable. A similar conclusion was posted on the website of the U.S. embassy in France in the mid-2000s.

As for deference to French views, the IRS cited a letter from a French official confirming that, under the SSA agreement, detached U.S. workers were not required to pay CSG or CRDS while working in France. (The Eshels did not qualify as detached workers, so the exemption did not apply to their circumstances.) Presumably, the IRS believed the exemption made the taxes more closely resemble social charges, because detached workers typically pay income taxes in their host country and social charges in their home country.

The problem with that argument is that it conflates the treatment of detached workers with the general provisions of the SSA agreement — and with the long-standing view of the French government that these are income taxes and not social charges. Moreover, it fails to consider the treatment of detached French workers in the United States. They also do not pay CSG and CRDS, although they do pay French social security taxes. This more clearly displays that France considers them income taxes.

[7] *See Eshel v. Commissioner*, 142 T.C. 197 (2014).

The Tax Court also considered European litigation involving the CSG and CRDS. Following their enactment, the European Commission became concerned that the taxes infringed on fundamental freedoms (the free movement of labor) in how they applied to French residents who worked in other EU member states — for example, a French plumber who worked across the border in neighboring Belgium. If these taxes were viewed as social charges, applying them to the earnings of such workers would violate European Council Regulation No. 1408/71 and result in double taxation, because the wages would be concurrently subject to social charges in the host country. The Court of Justice of the European Union agreed with the commission, forcing the French government to eventually amend its laws to bring the taxes into compliance (*Commission v. France*, joined cases C-34/98 and C-169/98 (CJEU 2000)).

On appeal to the D.C. Circuit, the taxpayers argued that the finding of an EU infringement proceeding had nothing to do with the issue at hand, which was whether the CSG and CRDS operated to "amend or supplement" the enumerated taxes under the SSA agreement. Infringement is a different kettle of fish. That was established in a separate CJEU case a few years later (*Derouin v. URSSAF*, C-103/06 (CJEU 2008)). *Derouin* concerned a French lawyer who was a partner in the Paris office of a British law firm. He argued that the France-U.K. tax treaty exempted him from the CSG and CRDS as to that portion of his income attributable to the firm's U.K. head office, meaning he remained liable for CSG and CRDS on that portion of income attributable to the French office. Basically, this argues that the residence country (France) has taxing rights for social security purposes, while the source country (U.K.) has taxing rights for income tax purposes, through the country's tax treaty. These facts differ from the case of the French plumber, discussed above, because Derouin didn't leave the country to perform his work.

The CJEU confirmed that France must implement the CSG and CRDS in a manner that's consistent with EU law. It then went further to hold that: (1) France, through the treaty, ceded taxing rights to the United Kingdom regarding U.K.-source income earned by a French resident;

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and (2) that the CSG and CRDS are to be considered income taxes under the treaty. The case was remanded to a lower French court, which later held that CSG and CRDS were income taxes that could not apply to U.K.-source income by operation of the treaty.

The Tax Court seems to have cherry-picked which bits of CJEU jurisprudence it paid attention to, basically ignoring the *Derouin* case. On appeal, the D.C. Circuit found numerous errors. Prominent among these was the failure to draw comparisons to code section 1411, which helps fund the U.S. Social Security programs by taxing the earnings of detached French workers who temporarily reside in the United States. Section 1411 does so without creating any entitlement to future benefits. Such workers are exempt from U.S. Social Security taxes, per the SSA agreement, but are required to pay the tax under section 1411. This demonstrates that a tax can, at once, support a country's social programs yet still fall outside the scope of a totalization agreement. A perfect analogy to the CSG and CRDS. The D.C. Circuit also criticized the Tax Court for resorting to American dictionaries to decipher the meanings of "amend" and "supplement" for these purposes. That wasn't just tacky; it was legal error.

The D.C. Circuit's reversal of the Tax Court isn't new; it came out in August 2016. What's been going on since then? The U.S. State Department negotiated with their French counterparts to resolve the matter at the diplomatic level. The results are contained in the joint status report, which confirms that CSG and CRDS do not amend or supplement the SSA agreement. It's safe to say that the IRS does not like that outcome, but it had no choice in the matter. The State Department controls the U.S. government's position on totalization agreements.

The floodgates are now open for refund claims from other taxpayers. The applicable statute of limitations is 10 years, per section 6511(d)(3). Tax years from 2009 on should be in play, and possibly 2008 as well, depending on whether IRS conduct acted to toll the statute. We're not sure how many U.S. expats live in France, but those who do should take note that CSG and CRDS are creditable against their U.S. income taxes. The total value of refund claims is difficult to estimate. Horwich knows of one refund case that exceeds $1 million; most will be for much less.

Not all principle cases turn out this well. For the affected taxpayers, it's been a long time coming. ■

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