EXPLANATION OF PROPOSED PROTOCOL TO THE ESTATE, INHERITANCE, AND GIFT TAX TREATY BETWEEN THE UNITED STATES AND FRANCE

Scheduled for a Hearing

Before the

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On February 2, 2006

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

January 26, 2006
JCX-3-06

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the treaty between the United States and France relating to estate, inheritance, and gift taxes (the "proposed protocol"). The proposed protocol was signed on December 8, 2004.[2] The proposed protocol would modify the estate, inheritance, and gift tax treaty between the United States and France that was signed on November 24, 1978 (the "treaty"). The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol on February 2, 2006.

Part I of the pamphlet provides a summary of the proposed protocol. Part II contains a brief description of the relevant French tax law. Part III contains an article-by-article explanation of the proposed protocol. Part IV contains a discussion of an issue raised by the proposed protocol.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Estate, Inheritance, and Gift Tax Treaty Between the United States and France* (JCX-3-06), January 26, 2006.

[2] For a copy of the proposed protocol, *see* Senate Treaty Doc. 109-7, November 4, 2005.

II. SUMMARY

An estate, inheritance, and gift tax treaty currently is in force between the United States and France. In the case of the United States, the treaty applies to the estate, gift, and generation-skipping transfer taxes. These taxes apply to the transfer of property by a donor during life, through a decedent's estate, or by generation-skipping transfer. Generation-skipping transfers involve transfers that skip a generation, as would be the case of a transfer by a donor to the donor's grandchild. In the case of France, the treaty applies to the duties on gifts and on succession (inheritance). Generally, these French duties apply to similar transfers to those subject to the U.S. estate and gift taxes, but are imposed on the recipient of property, rather than on the transferor.

The principal purpose of the estate, inheritance, and gift tax treaty between the United States and France is to reduce or eliminate double taxation in connection with estate, inheritance, and gift taxes. One of the general principles of the treaty is that the country in which a donor or decedent was domiciled may tax the estate or gifts of that individual on a worldwide basis, but must credit tax paid to the other country with respect to certain types of property located in such other country. Specifically, immovable property, certain business assets, and partnership interests attributable to such property are taxable in the country in which such property is situated.

The proposed protocol would make several updates and other modifications to the treaty. Among other updates, the proposed protocol would add a "saving clause," which would protect the right of the United States to apply its estate and gift tax rules to U.S. citizens, as well as to certain former U.S. citizens and long-term residents.

The proposed protocol also would provide a pro rata unified credit to the estate of an individual domiciled in France (other than a U.S. citizen) for purposes of computing the U.S. estate tax due. An estate eligible for this provision would be entitled to a portion of the full, generally applicable credit, based on the ratio of the value of the estate's U.S.-situated assets to the value of its worldwide assets.

In addition, the proposed protocol would provide a limited U.S. estate tax marital deduction in cases in which the surviving spouse is not a U.S. citizen. This provision would apply in the case of certain small estates. The proposed protocol also would add new limits to the situs-based taxation of certain interspousal transfers of noncommunity property.

III. FRENCH INHERITANCE, GIFT, AND WEALTH TAXES[3]

France levies inheritance tax at the time of death on the worldwide assets of French residents, and on the French-situated assets of nonresidents. Tax rates and exemption amounts vary depending on the identity of the recipient. In addition, a gift tax is generally levied on the transfer by gift of property exceeding a threshold value amount.

Wealth tax is imposed annually on individuals resident or owning property in France, at progressive rates of up to 1.8 percent of the worldwide net worth of resident individuals, or the French-situated net worth in the case of nonresident individuals. An exemption roughly equivalent to $900,000 applies. Financial assets of nonresident individuals are exempt from the tax.

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[3] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part "French Taxation," a publication of the French Ministry of the Economy, Finance and Industry.

IV. EXPLANATION OF PROPOSED PROTOCOL

Article I. Estates and Gifts Covered

The proposed protocol would add a "saving clause" to Article 1 (Estates and Gifts Covered) of the existing treaty. Pursuant to this saving clause, the United States would retain the right to tax under U.S. law the estates or gifts of: (1) U.S. citizens; (2) U.S. domiciliaries (within the meaning of Article 4 (Fiscal Domicile) of the treaty); and (3) former U.S. citizens or long-term residents in cases in which loss of citizenship or residency status had as one of its principal purposes the avoidance of U.S. tax, but only for a period of 10 years following such loss of status.

The Technical Explanation states that the provision regarding former citizens and long-term residents is intended to be consistent with the U.S. expatriation tax regime set forth in Code sections 877, 2107, and 2501(a)(3). The Congress made substantial changes to this regime in the American Jobs Creation Act of 2004 ("AJCA"), which was signed into law on October 22, 2004.

Under the regime prior to its amendment by AJCA, if a former U.S. citizen or long-term resident relinquished U.S. citizenship or terminated U.S. residency with a principal purpose of avoiding U.S. taxes, the individual was subject to a special set of income, estate, and gift tax rules for the 10-year period following such loss of status. Under present and prior law, these rules mainly have the effect of expanding the scope of income and wealth transfers that are subject to taxation by the United States, such that the individual is subject to U.S. tax on a somewhat broader basis than other nonresident aliens, but still on a narrower basis than a current U.S. citizen or resident. Under prior law, for purposes of determining the applicability of the regime, an individual who relinquished citizenship or terminated residency was treated as having done so with a principal purpose of tax avoidance if the individual's average Federal income tax liability or net worth exceeded certain monetary thresholds, but certain categories of individuals (e.g., dual residents) could avoid this presumption by requesting a ruling from the IRS that they did not have such a principal purpose, based on the relevant facts and circumstances.

AJCA eliminated these subjective determinations of tax-avoidance purpose and replaced them with objective rules. Under the regime as amended by AJCA, a former citizen or former long-term resident is subject to the special income, estate, and gift tax rules for expatriates unless the individual: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all Federal tax obligations for the preceding five years and provides such evidence of compliance as the Treasury Secretary may require. Thus, as a result of AJCA, the application of the expatriation tax regime no longer turns on determinations of whether a person had a principal purpose of tax avoidance, as it often did prior to AJCA.

The Technical Explanation notes that under the proposed protocol, the determination of whether there was a principal purpose of tax avoidance with respect to former citizens or long-term residents of the United States is made under the laws of the United States. The Technical

Explanation further states that this language would include "the irrebuttable presumptions based on average annual net income tax liability and net worth under section 877," and that the new objective tests "represent the administrative means by which the United States determines whether a taxpayer has a tax avoidance purpose." Thus, although the proposed protocol employs the now-obsolete concept of a tax-avoidance purpose, the Technical Explanation states that this language should be understood as fully preserving U.S. taxing jurisdiction under the expatriation tax rules in their current form.

The proposed protocol provides exceptions to the saving clause that preserve certain obligations of the United States under the treaty (as amended by the proposed protocol), specifically the benefits conferred by the United States under Article 10 (Charitable Exemptions and Deductions); paragraph 2 of Article 11 (Community Property and Marital Deduction), relating to the marital exclusion for interspousal transfers of certain types of noncommunity property; paragraphs 2 and 8 of Article 12 (Exemptions and Credits), mainly requiring the United States to credit taxes paid to France on either a domiciliary or a situs basis; Article 13 (Time Limitations on Claims for Credit or Refund); and Article 14 (Mutual Agreement Procedure). The benefits of paragraph 3 of Article 11 (Community Property and Marital Deduction), relating to a limited estate tax marital deduction for property passing to a spouse who is not a U.S. citizen, also are not subject to the saving clause, except with respect to former U.S. citizens and long-term residents subject to the proposed protocol's expatriation provision. The benefits of Article 17 (Diplomatic and Consular Officials) are not subject to the saving clause with respect to transfers by individuals who have neither U.S. citizenship nor immigrant status in the United States.

<u>Article II. General Definitions</u>

The proposed protocol would replace paragraph 2 of Article 3 (General Definitions) of the treaty and provide that any term not otherwise defined in the treaty shall, unless the context otherwise requires or the competent authorities agree to a common meaning, have the meaning which it has under the law of the treaty country for the purposes of the taxes of which the treaty applies. The proposed protocol also would provide that any meaning under the tax laws of such treaty country will prevail over a meaning given under other laws of that country.

<u>Article III. Real Property</u>

The proposed protocol would replace Article 5 (Immovable (Real) Property) of the treaty. Like the existing treaty, the proposed protocol would provide that real property may be taxed by the treaty country in which the property is situated. The Technical Explanation notes that this is a primary taxing right, but not an exclusive one. Thus, for example, the proposed protocol would allow the United States to tax the transfer of French-situs real property by a U.S. domiciliary, as long as the United States allows a credit for the French tax. This provision also applies to real property of an enterprise and real property used for the performance of independent personal services, regardless of where the enterprise is located or where the independent personal services are performed.

As under the existing treaty, the proposed protocol would provide that the term "real property" is defined under the law of the treaty country in which the property is situated (although in no event can mortgages or other debt-claims secured by real property be regarded as real property). The proposed protocol also would include in the definition of "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 would not be regarded as real property.

The proposed protocol also would include in the definition of "real property" shares, participations, and other rights in a company or legal person the assets of which consist, directly or indirectly, at least 50 percent of real property situated in one of the treaty countries, or of rights pertaining to such property. These shares, participations and other rights would be deemed situated in the treaty country in which the real property is situated. The Technical Explanation explains that this provision is intended to prevent taxpayers from avoiding taxation in the treaty country in which real property is situated by holding the property indirectly.

Article IV. Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Professional Services

Under Article 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Professional Services) of the current treaty, assets forming part of the business property of a permanent establishment of an enterprise generally may be taxed by the treaty country in which the permanent establishment is situated. A "permanent establishment" for this purpose is a fixed place of business through which the business of an enterprise is wholly or partly carried on. For these purposes, a member of a partnership (or other association that is not a corporation) engaged in industrial or commercial activity through a fixed place of business is deemed to be so engaged to the extent of such member's interest therein. The proposed protocol would replace the phrase "other association that is not a corporation" with "other similar pass-through entity." The Technical Explanation states that this revision was made to take into account changes made in 1996 to the U.S. entity classification regulations. The proposed protocol would make clear that an individual member of any type of pass-through entity which is engaged in industrial or commercial activity through a fixed place of business will be deemed to be so engaged to the extent of such member's interest therein.

Article V. Charitable Exemptions and Deductions

Under Article 10 (Charitable Exemptions and Deductions) of the current treaty, a transfer to a legal entity created or organized in one treaty country is exempt from tax, or fully deductible from the gross value liable to tax, in the other treaty country, if the transfer would be eligible for such treatment if the entity had been created or organized in the other treaty country. This rule applies only if the legal entity to which property is transferred: (1) has tax-exempt status in the country in which it is created or organized by reason of which transfers to it are exempt or fully deductible from the taxes covered by the treaty; (2) is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; and (3) receives a substantial part of its support from contributions from the public or from government funds.

The proposed protocol would amend Article 10 of the treaty to add “cultural” to the list of enumerated purposes for which the legal entity can be organized and operated.

Article VI. Community Property and Marital Deduction

The proposed protocol amends Article 11 (Community Property and Marital Deduction) of the treaty. The proposed protocol would require the United States to exclude from the U.S. taxable base certain interspousal transfers of noncommunity property from domiciliaries of France to a spouse who is not a U.S. citizen. Specifically, under the proposed protocol, noncommunity property that may be taxed by the United States solely on the basis of situs (i.e., under Article 5 (Real Property), Article 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Based Used for the Performance of Professional Services), or Article 7 (Tangible Movable Property)) may be included in the taxable base of the United States only to the extent that the value of such property, taking into account any applicable deductions, exceeds 50 percent of the value of all of the property taxable by the United States. Thus, noncommunity property potentially taxable in the United States under the aforementioned provisions of the treaty transferred from a French domiciliary to a spouse who is not a U.S. citizen may be taxed by the United States only to the extent that it exceeds 50 percent of the net value of all property which may be taxed by the United States. This exclusion does not apply to the estate of, or gifts made by, a U.S. citizen domiciled in France or a former citizen or long-term resident of the United States whose loss of such status had as one of its principal purposes the avoidance of tax (as defined under U.S. internal law), for a period of 10 years following such loss.

The proposed protocol also allows a marital deduction in connection with transfers of “qualifying property” satisfying all of the following conditions: (1) the decedent must have been, at the time of death, domiciled in either France or the United States, or a citizen of the United States; (2) the surviving spouse must have been, at the time of the decedent’s death, domiciled in either France or the United States; (3) if both the decedent and the surviving spouse were domiciled in the United States at the time of the decedent’s death, at least one of them must have been a citizen of France; and (4) the executor of the decedent’s estate must elect the benefits of this marital deduction provision and waive irrevocably the benefits of any estate tax marital deduction that otherwise would be allowed under U.S. internal law (on a Federal estate tax return filed by the deadline for making a qualified domestic trust election under Code section 2056A(d)). In the case of an estate with respect to which the Federal estate tax return is filed on or before the date on which the proposed protocol enters into force, the election and waiver described above must be made on a return filed to claim a refund pursuant to the special retroactive effective date applicable to such estates (discussed below with respect to Article IX of the proposed protocol).

“Qualifying property” is property passing to the surviving spouse (within the meaning of U.S. internal law), which would have qualified for the estate tax marital deduction under U.S. internal law if the surviving spouse had been a U.S. citizen and all applicable elections had been properly made. As the Technical Explanation notes, because one of the requirements of the marital deduction under U.S. internal law is that the property be included in determining the value of the gross estate, property will not qualify for the marital deduction under the proposed protocol to the extent that the property is excluded from the decedent’s gross estate by reason of other provisions of the treaty, such as the 50-percent rule for situs-based taxation of certain transfers of noncommunity property described above.

The amount of the marital deduction allowed under the proposed protocol is equal to the lesser of the value of the qualifying property or the "applicable exclusion amount" (within the meaning of U.S. internal law, determined without regard to any gift previously made by the decedent). The "applicable exclusion amount" is determined under Code section 2010. For decedents dying in 2006, 2007, or 2008, the applicable exclusion amount for estate tax purposes is $2 million. The applicable exclusion amount increases to $3.5 million for estates of decedents dying in 2009. Estates of decedents dying during 2010 are not subject to the estate tax. The estate tax then returns into force with respect to estates of decedents dying in 2011 or later, with an applicable exclusion amount of $1 million.

The Technical Explanation notes that, in certain cases, the proposed protocol's marital deduction provision may affect the U.S. estate taxation of a trust that would meet the requirements for a qualified terminable interest property ("QTIP") election (for example, a trust with a life income interest for the surviving spouse and a remainder interest for other family members) or a qualified domestic trust ("QDOT") election. If, in lieu of making the QTIP election or the QDOT election, the decedent's executor makes the election described above under the proposed protocol, the provisions of Code sections 2044 (regarding inclusion in the estate of the second spouse of certain property for which the marital deduction was previously allowed), 2056A (regarding qualified domestic trusts), and 2519 (regarding dispositions of certain life estates) would not apply. To obtain this treatment, however, the executor is required to waive the benefit of any marital deduction otherwise allowable under the Code with respect to the trust.

Article VII. Exemptions and Credits

In general

The proposed protocol replaces Article 12 (Exemptions and Credits) of the existing treaty. As under the current treaty, the proposed protocol would require each treaty country to impose its tax, and to allow exemptions, deductions, credits, and other allowances, in accordance with its own internal laws, except as otherwise provided in the treaty.

Like the current treaty, the proposed protocol provides specific rules for relieving double taxation. In cases in which France imposes tax on the basis of the domicile (as determined under Article 4 (Fiscal Domicile)) of the decedent or donor, France may tax the entire property comprising the estate or the gift, but must allow "a deduction from that tax" (i.e., a credit) for any U.S. tax imposed in accordance with the treaty on the transfer of property in relation to the same event (e.g., in accordance with Article 5 (Real Property), Article 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Based Used for the Performance of Professional Services), Article 7 (Tangible Movable Property), or the saving clause of paragraph 4 of Article 1 (Estates and Gifts Covered)). This credit, however, shall not exceed that part of the French tax, as computed before any deduction is made, which is attributable to the property in respect of which the credit is to be allowed.

The Technical Explanation explains that, under French law, the rates of the inheritance and gift tax are determined on the basis of the proximity of relationship between the deceased or the donor and the beneficiary or the donee. In general, graduated rates are imposed in cases in which there is a close proximity of relationship, and flat rates are imposed in cases in which there is no such close proximity. Where the amount of the French tax is computed by applying graduated rates, France must allow a deduction for any U.S. tax imposed in accordance with the treaty, up to the amount computed by multiplying the taxable net value of the property in respect of which the deduction is to be allowed by the ratio of the French tax actually payable on the total property taxable in accordance with French law to the net value of that total property. In other words, the upper limit on the deduction that France must allow is computed by multiplying the amount of the property also subject to U.S. tax by the average rate of French tax actually payable on all the property comprising the estate or the gift. Where the amount of the French tax is computed by applying a flat rate, however, the upper limit on the deduction that France must allow is computed by multiplying the amount of the property also subject to U.S. tax by the rate actually applicable to the property in respect of which the deduction is to be allowed.

The taxes for which France must allow a deduction, as described above, include the U.S. Federal estate and gift tax, except where such taxes are imposed solely pursuant to the saving clause. In addition, in a case in which the United States imposes tax on the basis of situs, France is obligated to allow a deduction for such tax only if the decedent (at the time of his death) or the donor (at the time of the gift) was a United States citizen and the tax is actually paid.

Under the proposed protocol, where both treaty countries impose tax with respect to property which is taxable by France in accordance with Articles 5, 6, or 7, the United States must allow a credit equal to the amount of the tax imposed by France with respect to such property. If a decedent or donor was a citizen of the United States at the time of death or the making of a gift, and such person is considered under the treaty as having been domiciled in France, the United States must allow a credit equal to the amount of the tax imposed by France, net of any deduction from tax allowed under the treaty. In addition, if the United States includes property in a decedent's estate solely because he was a former citizen or long-term resident of the United States whose loss of such status (within 10 years of the date of death) had as one of its principal purposes the avoidance of tax, the United States must allow a credit equal to the amount of the tax imposed by France in respect of all such property. The total amount of credits allowed by the United States cannot exceed that portion of the U.S. tax which is attributable to such property. The part of the tax deemed to be so attributable is to be determined in accordance with the principles of Code section 2014(b)(2) of the Code and section 20.2014-3 of the estate tax regulations.

Pro rata unified credit

U.S. internal law

Under U.S. internal law, the estate of a nonresident alien is subject to U.S. estate tax only on its U.S.-situs assets and is entitled to a unified credit of $13,000 (for a $60,000 exclusion equivalent amount). The estate of a U.S. citizen or U.S. resident is subject to U.S. estate tax on its entire worldwide assets and is entitled to a unified credit in an amount determined under Code section 2010. For decedents dying in 2006, 2007, or 2008, the unified credit is $780,800 (for a

$2 million exclusion equivalent amount), increasing to $1,455,800 for estates of decedents dying in 2009 (for a $3.5 million exclusion equivalent amount). As noted earlier, estates of decedents dying during 2010 are not subject to the estate tax, but then this one-year repeal of the estate tax terminates, and the unified credit is $345,800 for estates of decedents dying in 2011 or later years (for a $1 million exclusion equivalent amount). A lower unified credit is provided for the estate of a nonresident alien because it is assumed that such estates generally will hold fewer U.S.-situs assets as a percentage of the estate's total assets, and thus will have a lower U.S. estate tax liability.

Proposed protocol modification of internal law

The proposed protocol grants a pro rata unified credit to the estate of a decedent (other than a U.S. citizen) domiciled in France for purposes of computing the U.S. estate tax. Provisions similar to this and the marital deduction against U.S. estate tax in respect of certain transfers to a surviving spouse (discussed above) were included in the U.S.-Canada income tax treaty and the U.S.-Germany estate tax treaty, approved by the Senate in 1995 and 2000, respectively.

Subject to certain limitations, the pro rata unified credit provision increases the credit allowed to the estate of a non-U.S. citizen domiciled in France to an amount between $13,000 and the unified credit available to a U.S. citizen, to take into account the extent to which the assets of the estate are situated in the United States. In no event will the amount of the unified credit allowed to the estate of a non-U.S. citizen decedent domiciled in France be less than the $13,000 allowed under U.S. internal law to the estate of a nonresident alien (subject to the adjustment for prior gift tax unified credits, discussed below).

Subject to the adjustment for any gift tax unified credit previously allowed against gift tax liability, the pro rata unified credit is determined by multiplying the unified credit available to a U.S. citizen under Code section 2010 for the year in which the decedent dies (e.g., $780,800 in 2006) by a fraction, the numerator of which is the value of the part of the gross estate situated in the United States and the denominator of which is the value of the entire gross estate wherever situated. Thus, if a non-U.S. citizen domiciled in France dies in 2006, and half of the entire gross estate (by value) is situated in the United States, the estate would be entitled to a pro rata unified credit of $390,400 against any U.S. estate tax otherwise owed. For purposes of this computation, assets are treated as situated in the United States only if the United States is allowed to tax them under the treaty.

The amount of the unified credit otherwise allowable is reduced by the amount of any unified credit previously allowed against U.S. gift tax imposed on any gift by the decedent. The Technical Explanation notes that, under U.S. internal law, the only circumstance under which any unified credit would have been previously allowed is where the decedent made gifts subject to the U.S. gift tax while a U.S. citizen or resident. Entitlement to the pro rata unified credit also is contingent upon the provision of all information necessary for the verification and computation of the credit (e.g., information establishing both the value of the worldwide estate and the value of the U.S. portion of the estate). The Technical Explanation notes that substantiation requirements also apply with respect to other provisions of the proposed protocol and the treaty, but explains that it was considered advisable to emphasize the substantiation requirements in connection with this provision, because the computation of the pro rata unified credit involves certain information not otherwise relevant for U.S. estate tax purposes.

Other deduction and credit issues

Under the proposed protocol, in determining the French gift or inheritance tax with respect to transfers by a donor or decedent who, at the time of making the gift or at death, was a citizen of the U.S. or was domiciled in the U.S., the same deductions and credits must be allowed as would be allowed if the individual were domiciled in France. In addition, in determining the French gift or inheritance tax with respect to transfers by a donor or decedent who, at the time of making the gift or at death, was domiciled in France to an individual who is a U.S. citizen or is domiciled in the U.S., the same deductions and credits must be allowed as would be allowed if the individual were domiciled in France.

Credits or deductions for tax imposed by a treaty country allowable under the treaty are in lieu of, and not in addition to, any credits or deductions for such taxes allowed by the internal laws of the other treaty country and must be computed according to and subject to the limitations of the law of such other treaty country, as may be amended from time to time without changing the general principle thereof.

A treaty country is not prohibited from imposing tax in a case in which property is taxable under the treaty only in the other treaty country, but the taxpayer in fact does not pay the tax to the other treaty country (other than as a result of a specific exemption, deduction, exclusion, credit, or allowance).

In cases in which the treaty prevents property from being taxed by one treaty country, that country may nevertheless take into account such exempt property that would otherwise be taxable under its internal law in calculating the amount of tax on the property that may be taxed by that country under the treaty. In other words, exempt property may be included in the tax base for purposes of determining the tax rate applicable to non-exempt property under a progressive rate schedule.

The provisions of the treaty may not result in an increase in the amount of the tax imposed by either treaty country under its domestic laws. A reduction in the credit allowed against a treaty country's tax for tax paid to the other treaty country, which reduction results from the application of the treaty, is not for these purposes to be construed as an increase in tax. The Technical Explanation notes that this provision prevents taxpayers from arguing that an estate would have received a higher foreign tax credit without the treaty, because it would have paid more French taxes, and thus should be allowed the higher foreign tax credit even though the treaty reduced the estate's French tax.

Article VIII. Filing of Returns and Exchange of Information

The proposed protocol makes a minor amendment to Article 15 (Filing of Returns and Exchange of Information) of the treaty. Under this article, the competent authority of each treaty country is required to exchange certain information with the competent authority of the other treaty country. Any information furnished under this provision must be treated as secret by the recipient country. Under the language of the proposed protocol, this information may be disclosed only to persons "*involved in* the assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of [the treaty]" (emphasis added). The language of the existing treaty refers to persons "concerned with" such activities, which some may construe as inappropriately broad.

Article IX. Entry Into Force

The proposed protocol generally would enter into force upon the exchange of instruments of ratification and would have effect with respect to deaths occurring and gifts made after that date.

A special retroactive effective date applies with respect to the provisions of the proposed protocol relating to the pro rata unified credit and the limited U.S. estate tax marital deduction. The proposed protocol provides that these provisions would have effect with respect to deaths occurring and gifts made after November 10, 1988,[4] notwithstanding any limitation imposed under internal law on the assessment, reassessment, or refund with respect to a person's or estate's return, and provided that any return or claim for refund asserting the benefits of the proposed protocol is filed before the date that is one year after the first day of the second month following the date on which on which the proposed protocol enters into force, or within the otherwise applicable period for filing such claims under internal law.

Additionally, the saving clause applies to any such claim for refund. Where an estate, prior to entry into force of the proposed protocol, was allowed a marital deduction for a transfer to a qualified domestic trust under Code section 2056A(d), such estate may elect to treat the qualified domestic trust as if it had never been established in order to claim the benefits of paragraph 3 of Article 11 or paragraph 3 of Article 12, as long as it does so within the time for filing a claim for refund referred to above. Where such an election is made, the property is treated as having been transferred to the surviving spouse at the time of the decedent's death for all purposes of the treaty.

[4] November 10, 1988, is the effective date of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). In TAMRA, the Congress enacted several significant estate and gift tax changes affecting alien individuals, including the general disallowance of the marital deduction with respect to transfers to non-U.S. citizen spouses and the repeal of prior law's special tax rates and credits applicable to the estates of nonresident aliens.

V. ISSUE: EXPATRIATION TO AVOID TAX BY FORMER U.S. CITIZENS AND LONG-TERM RESIDENTS

There is a potential conflict between the special expatriation tax regime of U.S. internal law and the proposed protocol. The saving clause that the proposed protocol would add to the treaty uses the obsolete "principal purposes of tax avoidance" formulation in determining whether the special tax regime may apply to individuals who expatriate, even though the subjective determinations of tax-avoidance purpose under prior law were recently eliminated and replaced with objective rules for determining the applicability of the special tax regime.

Under the regime prior to its amendment by AJCA, if a former U.S. citizen or long-term resident relinquished U.S. citizenship or terminated U.S. residency with a principal purpose of avoiding U.S. taxes, the individual was subject to a special set of income, estate, and gift tax rules for the 10-year period following such loss of status. Under present and prior law, these rules mainly have the effect of expanding the scope of income and wealth transfers that are subject to taxation by the United States, such that the individual is subject to U.S. tax on a somewhat broader basis than other nonresident aliens, but still on a narrower basis than a current U.S. citizen or resident. Under prior law, for purposes of determining the applicability of the regime, an individual who relinquished citizenship or terminated residency was treated as having done so with a principal purpose of tax avoidance if the individual's average Federal income tax liability or net worth exceeded certain monetary thresholds, but certain categories of individuals (e.g., dual residents) could avoid this presumption by requesting a ruling from the IRS that they did not have such a principal purpose, based on the relevant facts and circumstances.

AJCA eliminated these subjective determinations of tax-avoidance purpose and replaced them with objective rules. Under the regime as amended by AJCA, a former citizen or former long-term resident is subject to the special income, estate, and gift tax rules for expatriates unless the individual: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all Federal tax obligations for the preceding five years and provides such evidence of compliance as the Treasury Secretary may require. Thus, as a result of AJCA, the application of the expatriation tax regime no longer turns on determinations of whether a person had a principal purpose of tax avoidance, as it often did prior to AJCA.

The Technical Explanation notes that under the proposed protocol, the determination of whether there was a principal purpose of tax avoidance with respect to former citizens or long-term residents of the United States is made under the laws of the United States. The Technical Explanation further states that this language would include "the irrebuttable presumptions based on average annual net income tax liability and net worth under section 877," and that the new objective tests "represent the administrative means by which the United States determines whether a taxpayer has a tax avoidance purpose." Thus, although the proposed protocol employs the now-obsolete concept of a tax-avoidance purpose, the Technical Explanation maintains that this language should be understood as fully preserving U.S. taxing jurisdiction under the expatriation tax rules in their current form.

The Committee may wish to satisfy itself that the language included in the proposed protocol allows the United States to exercise its full taxing jurisdiction with respect to former citizens and long-term residents. The Committee also may wish to inquire as to why the language of the proposed protocol was not updated to eliminate potential conflicts with section 877, as revised by AJCA.