[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED PROTOCOL TO THE CONVENTION BETWEEN THE UNITED STATES AND GERMANY FOR THE AVOIDANCE OF DOUBLE TAXATION WITH RESPECT TO TAXES ON ESTATES, INHERITANCES, AND GIFTS

SCHEDULED FOR A HEARING

BEFORE THE

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UNITED STATES SENATE

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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 Germany relating to estate, inheritance, and gift taxes. The proposed protocol was signed on December 14, 1998.[2] The proposed protocol would modify the estate, gift, and inheritance tax treaty between the United States and Germany that was signed on December 3, 1980. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol on October 13, 1999.

Part I of the pamphlet provides a summary of the proposed protocol. Part II contains an article-by-article explanation of the proposed protocol.

I. SUMMARY

In general

An estate, gift, and inheritance tax treaty currently is in force between the United States and Germany. In the case of the United States, the treaty applies to the U.S. estate, gift, and generation-skipping transfer taxes. These taxes apply to the transfer of property by a decedent's estate or a donor, at death, during life, or by a generation-skipping transfer. Generation-skipping transfers generally 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 Germany, the treaty applies to the inheritance and gift taxes. Generally, these taxes apply to similar transfers, but are imposed on the recipient of property from an estate or donor, rather than on the transferor.

The principal purpose of the existing estate, gift, and inheritance tax treaty between the United States and Germany is to reduce or eliminate double taxation on estate, gift, or inheritance 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 where such property is situated.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Convention Between the United States and Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts* (JCS–12–99), October 8, 1999.

[2] For a copy of the proposed protocol, see Senate Treaty Doc. 106–13, September 21, 1999.

Proposed modifications to the estate, gift, and inheritance tax treaty

The proposed protocol would make several modifications to the U.S.-Germany estate, gift, and inheritance tax treaty. First, the proposed protocol would modify certain tiebreaker rules in the treaty, that determine which country has the right to tax on a worldwide basis when a decedent or donor is treated as domiciled in both the United States and Germany at the time of death or at the time of making a gift. In this regard, the proposed protocol would extend from five to ten years the period of time during which a citizen of one country can be domiciled in the other country without becoming subject to the primary taxing jurisdiction of the other country.

Second, the proposed protocol would modify certain exemptions granted to transfers between spouses. The existing treaty provides that interspousal transfers of property are granted a 50-percent exemption. The proposed protocol would provide that the United States need not provide this exemption if the decedent or donor was a U.S. citizen, or was a former U.S. citizen or long-term resident whose loss of such status had as one of its principal purposes the avoidance of tax.

Third, the proposed protocol would provide a pro rata unified credit to the estate of an individual domiciled in Germany (who is not a U.S. citizen) for purposes of computing the U.S. estate tax. Under this provision, such an individual domiciled in Germany is entitled to a credit against U.S. estate tax based on the extent to which the assets of the estate are situated in the United States.

Fourth, the proposed protocol would provide a limited U.S. estate tax marital deduction when the surviving spouse is not a U.S. citizen. This provision would apply in the case of certain estates of limited value.

Finally, the proposed protocol would expand the saving clause of the treaty by expanding the types of persons who may be taxed by the United States. This provision would allow the United States to apply its estate and gift tax rules to former U.S. citizens and long-term residents whose loss of such status had as one of its principal purposes the avoidance of tax.

II. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the estate, gift, and inheritance tax treaty between the United States and Germany is set forth below.

Article 1

The proposed protocol would modify certain tiebreaker rules in the treaty which determine an individual's country of domicile where an individual is treated as domiciled in both countries. Under these rules, an individual is deemed to be domiciled in the country in which he or she has a permanent home. If the individual has a permanent home in both countries (or in neither country), then the individual's domicile is deemed to be the country in which his or her personal and economic relations were closest (*i.e.*, the individual's "center of vital interests"). If the individual's center of vital interests cannot be determined, then the individual's domicile is deemed to be the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries (or in neither country), then the individual's domicile is deemed to be the country of which he or she is a citizen. If the individual is a citizen of both countries (or of neither country), then the competent authorities of the countries will settle the issue of domicile by mutual agreement.

The existing treaty contains an exception to the tiebreaker rules described above. This exception applies where an individual was: (1) a citizen of one, but not the other, country; (2) domiciled in both countries according to the domestic laws of those countries; and (3) domiciled in the country of which he or she was not a citizen for not more than five years. When these conditions are met, the individual is deemed to be domiciled in the country in which he or she was a citizen for purposes of the treaty. This exception to the tiebreaker rules is based on the notion that a country should not tax the worldwide estate, gifts, or inheritances with respect to an individual domiciled therein if that individual has not been present in the country for a significant period of time.

The proposed protocol would amend the exception to the tiebreaker rules to extend from five to ten years the period during which an individual who otherwise meets the exception described above may be domiciled in the country of which he was not a citizen without being treated as domiciled in that country for purposes of the treaty. Thus, a U.S. citizen who is domiciled in both the United States and Germany under the laws of each country and who is domiciled in Germany for not more than 10 years would be deemed to be domiciled only in the United States (*i.e.*, his or her country of citizenship) for purposes of the treaty.

Article 2

The proposed protocol would modify certain exemptions granted for transfers between spouses under the treaty. Under the treaty, a country in which a decedent or donor was not domiciled may tax certain assets situated in that country (*e.g.,* immovable property, business property of a permanent establishment in that country, assets pertaining to a fixed base in that country for the purpose of performing independent personal services, and certain interests in partnerships). That country is required to provide certain deductions and exemptions with respect to the taxation of such property. For example, under the treaty, a country exercising its rights to impose a situs-based tax on such property is required to grant a 50-percent marital exclusion for interspousal transfers of certain types of non-community property from individuals domiciled in or citizens of the other country. Under this rule, interspousal transfers of such property may be included in the taxable base of the country where the property is located, but only to the extent that the value of such property exceeds 50 percent of the value of all property that may be taxed in that country.

The proposed protocol would provide that the 50-percent exemption described above would not apply if the decedent or donor was a U.S. citizen domiciled in Germany, or was a former U.S. 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. Thus, the United States would not be obligated to provide the marital exclusion benefits described above to the estate of or a gift made by such a person. According to the Treasury Department's Technical Explanation (the "Technical Explanation"), for example, a U.S. citizen who is domiciled in Germany under German law could, for purposes of the treaty, be deemed to have his domicile in Germany under the tiebreaker rules described above. In such a case, under the proposed protocol, the United States would not be required to provide the 50–percent marital exclusion with respect to interspousal transfers from that U.S. citizen to a spouse who is not a U.S. citizen.

Article 3

Pro rata unified credit

U.S. internal law

In general, under U.S. domestic law, U.S. citizens and residents are allowed a unified credit of $211,300 in 1999 against their cumulative lifetime U.S. estate and gift tax liability. The unified credit increases through 2006. The unified credit effectively exempts from the U.S. estate and gift tax transfers in the amount of $650,000 in 1999, $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1,000,000 in 2006 and thereafter (also referred to as the "applicable exclusion amount").

In general, the estate of a nonresident who is not a U.S. citizen is subject to U.S. estate tax only on his or her assets situated in the United States. Under Code section 2102(c)(1), the unified credit against the estate tax allowed to such nonresidents is $13,000.

Proposed treaty modification

The proposed protocol would provide a pro rata unified credit to the estate of an individual domiciled in Germany (who is not a U.S. citizen) for purposes of computing the U.S. estate tax. The unified credit for such persons would be the greater of (1) a pro rata portion of the unified credit which is allowed to U.S. citizens and residents, or (2) the unified credit allowed to the estate of a non-resident who is not a U.S. citizen under U.S. law (*i.e.,* $13,000). The pro rata portion would be based upon the ratio that the German resident's gross estate situated in the United States at the time of his death bears to his worldwide gross estate. The Technical Explanation states that, for example, if a non-U.S. citizen domiciled in Germany died in 1999 and half of his entire gross estate (by value) were situated in the United States, the U.S. estate would be entitled to a pro rata unified credit of $105,650. This credit must be reduced for any gift tax unified credit previously allowed for any gift made by the decedent. Allowance of the pro rata unified credit is conditioned upon the taxpayer providing sufficient documentation to verify the amount of the credit.

U.S. estate tax marital deduction

Where a surviving spouse is not a U.S. citizen, the proposed protocol would allow an estate to elect a limited U.S. estate tax marital deduction for property that would qualify for the marital deduction if the surviving spouse had been a U.S. citizen, provided that the following conditions are met: (1) at the time of the decedent's death, the decedent was domiciled in either Germany or the United States; (2) the decedent's surviving spouse was at the time of the decedent's death domiciled in either Germany or the United States; (3) if both the decedent and the decedent's surviving spouse were domiciled in the United States at the time of the decedent's death, one or both was a citizen of Germany; and (4) the executor of the decedent's estate irrevocably waives the benefits of any other estate tax marital deduction that would be allowed under the Code.

The marital deduction would equal the lesser of (1) the value of the qualifying property, or (2) the decedent's unified credit applicable exclusion amount (within the meaning of U.S. law determined without regard to any gift previously made by decedent). The Technical Explanation states that qualifying property must pass to the surviving spouse (within the meaning of U.S. domestic law) and be property that would have qualified for the estate tax marital deduction under U.S. domestic law if the surviving spouse had been a U.S. citizen and all applicable elections specified by U.S. domestic law had properly been made. As described above, the applicable exclusion amount for decedents dying in 1999 is $650,000.

The Technical Explanation provides an example of the operation of the new pro rata unified credit and the marital deduction that would be added by the proposed protocol. For example, assume husband (H) and wife (W) are both citizens and residents of Germany. H dies in the year 2000, when the unified credit is $220,550 and the applicable exclusion amount is $675,000. H has U.S. real property worth $2,000,000, all of which he bequeaths to W. The remainder of H's estate consists of $3,000,000 of property situated in Germany. Under the existing treaty, H's U.S. gross estate equals

$1,000,000 (the amount by which $2,000,000 of U.S. real property bequeathed to W exceeds 50 percent of the total value of U.S. property taxable in the United States under the treaty, or $1,000,000). H's worldwide gross estate equals $4,000,000 ($1,000,000 plus $3,000,000 of property situated in Germany).

Under the proposed protocol, H's $1,000,000 U.S. gross estate would be reduced by a $675,000 marital deduction (*i.e.,* the lesser of the applicable exclusion amount ($675,000) or the value of qualifying property transferred to the spouse ($2,000,000 in this case). This would result in a $325,000 U.S. taxable estate. The tentative tax on the taxable estate would be $96,300. However, under the proposed protocol, H's estate would also be entitled to a new pro rata unified credit of $55,138 (*i.e.,* $220,500 (the full unified credit for 1999) times $1,000,000/$4,000,000 (the U.S. gross estate over the worldwide gross estate)). Thus, under the proposed protocol, the total U.S. estate tax liability would be $96,300 minus $55,138, or $41,162.

Article 4

The proposed protocol would amend the saving clause of the existing treaty. Under the existing treaty, the United States retains the right to tax under U.S. law the estates or gifts of U.S. citizens. A "citizen" for this purpose includes a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax, but only for a period of 10 years after such loss of citizenship.

The proposed protocol would expand the saving clause to cover, in the case of the United States, two additional classes of individuals. First, under the proposed protocol, the United States generally would retain the right to tax under U.S. law the estates or gifts of individuals who, at the time of the transfer, were domiciled (within the meaning of Article 4 (Fiscal Domicile) of the treaty) in the United States. Second, under the proposed protocol, the United States generally would retain the right to tax under U.S. law the estates or gifts of individuals who, at the time of the transfer, were former long-term residents of the United States whose loss of such status had as one of its principal purposes the avoidance of tax, but only for ten years following the loss of such status.

In addition, the proposed protocol would permit Germany to retain the right to tax in accordance with German law an heir, donee, or another beneficiary who was domiciled (within the meaning of Article 4 (Fiscal Domicile) of the treaty) in Germany at the time of the death of the decedent or the making of the gift.

The existing treaty provides exceptions to the saving clause that preserve certain obligations of the countries under the treaty. The proposed protocol would add to these exceptions from the saving clause the pro rata unified credit and the U.S. estate tax marital deduction that would be added under the proposed protocol. However, these additional exceptions from the saving clause would not apply to the estates of former U.S. citizens and long-term residents whose loss of status had as a principal purpose the avoidance of tax, for a period of ten years following the loss of such status.

Article 5

The proposed protocol provides that it is subject to ratification in accordance with the applicable procedures in the United States and Germany, and that instruments of ratification will be exchanged as soon as possible. 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 effective date rule applies with respect to the pro rata unified credit and the limited U.S. estate tax marital deduction (Article 3 of the proposed protocol), as well as the expansion of the saving clause (Article 4 of the proposed protocol). The proposed protocol provides that such provisions would have effect with respect to deaths occurring and gifts made after November 10, 1988, [3] notwithstanding any limitation imposed under the law of a country 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 are filed within one year of the date on which the proposed protocol enters into force or within the otherwise applicable period for filing such claims under domestic law.

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[3] November 10, 1988, is the effective date of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). In TAMRA, Congress passed several significant estate and gift tax changes affecting alien individuals. First, the marital deduction generally was disallowed on transfers to non-U.S. citizen spouses. Second, the special tax rates and credits applicable to the estates of nonresident aliens prior to TAMRA were repealed.