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PROTOCOL AMENDING THE TAX CONVENTION WITH GERMANY

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Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 106–13]

The Committee on Foreign Relations, to which was referred the Protocol Amending the Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts, signed at Bonn on December 3, 1980, signed at Washington on December 14, 1998, having considered the same, reports favorably thereon, with one declaration and one proviso, and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

CONTENTS

I. PURPOSE

One of the principal purposes of the existing treaty is to reduce or eliminate double taxation on estate, gift, and inheritance taxes. A general principle of the existing 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

79–119

located in such other country. One of the principal purposes of the proposed protocol is to expand the United States' jurisdiction to tax its citizens and certain former citizens and long-term residents. The proposed protocol also would provide a pro rata unified credit to the estate of a German domiciliary and a U.S. estate tax marital deduction for estates of limited value if the surviving spouse is not a U.S. citizen.

II. BACKGROUND

The proposed protocol was signed on December 14, 1998. The proposed protocol amends the current estate, gift, and inheritance tax treaty between the United States and Germany that was signed in 1980.

The proposed protocol was transmitted to the Senate for advice and consent to its ratification on September 21, 1999 (see Treaty Doc. 106–13). The Committee on Foreign Relations held a public hearing on the proposed protocol on October 27, 1999.

III. 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.

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.

IV. Entry Into Force

The proposed protocol generally would enter into force upon the exchange of instruments of ratification and would take 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). Such provisions take effect with respect to deaths occurring and gifts made after November 10, 1988, provided that any return or claim for refund asserting the benefits of the proposed protocol are filed within one year of entry into force of the protocol or within the otherwise applicable period for filing such claims under domestic law.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed protocol with Germany (Treaty Doc. 106–13), as well as on other proposed treaties and protocols, on October 27, 1999. The hearing was chaired by Senator Hagel. The Committee considered these proposed treaties and protocols on November 3, 1999, and ordered the proposed protocol with Germany favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty, subject to a declaration and a proviso.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that the proposed protocol with Germany is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed protocol, and believes that the following comments may be useful to the Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. RECIPROCAL BENEFITS

Pro rata unified credit for German residents

In the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), Congress passed Code section 2102(c)(3), which permits a "pro rata" unified credit for nonresidents to the extent provided by treaty. The pro rata portion of the unified credit is based upon the ratio that the decedent's gross estate situated in the United States at the time of his death bears to his worldwide gross estate. Paragraph 5 of Article 3 of the proposed protocol provides such a pro rata unified credit to German residents who are not U.S. citizens.[1]

Under the proposed protocol, however, U.S. citizens and residents who are subject to situs-based taxation in Germany would not have the benefit of a provision similar to the pro rata unified credit. For example, under the proposed protocol, a German citizen or resident who has U.S.-situated property which passes to a German resident beneficiary would receive the benefit of the pro rata unified credit, whereas a U.S. citizen or resident who has German-situated property which passes to a U.S. resident beneficiary would not be entitled to a benefit similar to a pro rata unified credit.

Estate tax marital deduction for German residents

To determine the taxable estate of a decedent for U.S. estate tax purposes, a deduction generally is allowed for the value of any property that passes to his or her surviving spouse. TAMRA, however, eliminated this marital deduction where the surviving spouse is not a U.S. citizen (except for transfers to a "qualified domestic trust" ("QDOT") or where the surviving spouse becomes a U.S. citizen). Several countries have sought U.S. treaty relief from this TAMRA provision, including some countries with pre-TAMRA U.S. estate tax treaties that have provisions relating to the marital deduction. The proposed protocol contains an agreement by the United States to provide such relief.

Paragraph 6 of Article 3 of the proposed protocol provides a limited marital deduction against the U.S. estate tax on property passing to a noncitizen spouse if the decedent and the surviving spouse meet certain requirements regarding citizenship and residency. In addition, the deduction is available only if the executor of the decedent's estate irrevocably waives the benefits of any estate tax marital deduction that may otherwise be allowed.

The deduction allowed under the proposed protocol equals 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 the decedent). This provision is similar to the approach taken in recent proposed legislation to grant a limited marital transfer credit to employees of "qualified international organizations."[2] The deduction amount under the proposed protocol gen-

[1] The saving clause of the proposed protocol preserves the ability of the United States to reduce to $13,000 the pro rata unified credit allowable under the proposed protocol with respect to 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.

[2] See, for example, H.R. 2760, 106th Cong., 1st Sess., introduced by Rep. Amo Houghton on August 5, 1999.

erally is sufficient to resolve a principal area of concern—the reduction of the estate tax burden on transfers of personal residences and retirement annuities.

The proposed protocol does not, however, provide a similar marital deduction against the German inheritance and gift tax on property passing to a spouse who is neither a citizen nor resident of Germany.[3] Thus, under the proposed protocol, a German citizen or resident who has U.S.-situated property that passes to a German resident spouse would receive the benefit of the limited marital deduction, whereas a U.S. citizen or resident who has German-situated property which passes to a U.S. resident spouse would not be entitled to a similar marital deduction.

Committee conclusions

The Committee recognizes that changes to the U.S. estate tax marital deduction as a result of TAMRA in 1988 prompted negotiations with Germany regarding the marital deduction provision in the proposed protocol. Furthermore, the willingness of the United States to enter into the proposed protocol was an important factor in Germany's ratification of the U.S.- Germany income tax treaty, which was signed in August 1989. The Committee also recognizes that the U.S. estate, gift, and generation-skipping transfer taxes and the German inheritance and gift taxes are not identical, and the credits, exclusions, and deductions under the U.S. regime and the exemptions under the German regime are dissimilar.

Nonetheless, the Committee expects that, in future treaty negotiations, the Treasury Department will seek appropriate benefits for U.S. citizens and residents even when the tax systems are different between the United States and the other country.[4] Moreover, the Committee wishes to stress that the granting of such relief to German citizens and residents under the proposed protocol without obtaining similar benefits for U.S. citizens and residents should not be viewed as precedent in future treaty negotiations with other countries that seek similar relief.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to cause a negligible change in fiscal year Federal budget receipts during the 1999–2008 period.

VIII. 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.

[3] Under German inheritance and gift tax law, when neither the decedent nor the surviving spouse who receives German-situated property reside in Germany, there is no marital exemption for the transfer of such property to the surviving spouse.

[4] Benefits similar to the pro rata unified credit and marital deduction were provided to Canadian residents in the protocol to the income tax treaty between the United States and Canada in 1995. An issue was raised at that time regarding the fact that it was the first time the United States entered into a tax treaty covering estate taxes with a country that does not impose an estate or inheritance tax.

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 existing 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 nonresident 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,[5] 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.

IX. TEXT OF THE RESOLUTION OF RATIFICATION

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Protocol Amending the Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts signed at Bonn on December 3, 1980, signed at Washington on December 14, 1998 (Treaty Doc. 106–13), subject to the declaration of subsection (a) and the proviso of subsection (b).

(a) DECLARATION.—The Senate's advice and consent is subject to the following declaration, which shall be binding on the President:

(1) TREATY INTERPRETATION.—The Senate affirms the applicability to all treaties of the constitutionally based principles of treaty interpretation set forth in Condition (1) of the resolution of ratification of the INF Treaty, approved by the Senate on May 27, 1988, and Condition (8) of the resolution of ratification of the Document Agreed Among the States Parties to the Treaty on Conventional Armed Forces in Europe, approved by the Senate on May 14, 1997.

(b) PROVISO.—The resolution of ratification is subject to the following proviso, which shall be binding on the President:

(1) SUPREMACY OF CONSTITUTION.—Nothing in the Protocol requires or authorizes legislation or other action by the United States of America that is prohibited by the Constitution of the United States as interpreted by the United States.

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[5] November 10, 1988, is the effective date of 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. Third, section 2102(c)(3) was passed, which permits a pro rata unified credit for nonresidents to the extent provided by treaty.