

TREASURY DEPARTMENT
TECHNICAL EXPLANATION OF THE PROTOCOL BETWEEN
THE UNITED STATES OF AMERICA
AND
THE FEDERAL REPUBLIC OF GERMANY
SIGNED AT WASHINGTON ON DECEMBER 14, 1998
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

Introduction

This is a technical explanation of the Protocol signed at Washington on December 14, 1998 (the "Protocol"), which amends 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 (the "Convention").

This Technical Explanation is an official guide to the Protocol. It explains policies behind particular provisions, as well as understandings reached during the negotiations with respect to the interpretation and application of the Protocol. This technical explanation is not intended to provide a complete comparison between the Protocol and the Articles of the Convention that it amends. To the extent that the Convention has not been amended by the Protocol, the Technical Explanation of the Convention remains the official explanation. References in this technical explanation to "he" or "his" should be read to mean "he or she" or "his or her."

Article 1

Article 1 of the Protocol amends Article 4 (Fiscal Domicile) of the Convention, which provides rules for determining an individual's domicile for purposes of the Convention and establishes rules for resolving cases of dual domicile.

Paragraph 3 of Article 4 of the Convention contains an exception to the tie-breaker rules of paragraph 2. It applies where an individual was: (a) a citizen of one, but not the other, Contracting State; (b) domiciled in both Contracting States according to the domestic laws of those States; and (c) domiciled in the Contracting State of which he was not a citizen for not more than 5 years. If all these conditions are met, the individual is deemed to be domiciled in the State of which he was a citizen. This provision is based on the concept that a Contracting State should not tax the estate or gifts of an individual on a domiciliary basis if the individual has not been present in that State for a significant period of time.

Article 1 of the Protocol amends paragraph 3(c) of Article 4 of the Convention to extend from 5 years to 10 years the period during which an individual who otherwise meets the requirements of paragraph 3 may be domiciled in the Contracting State of which he was not a citizen without being treated as a resident of that State for purposes of the Convention. For example, if a U.S. citizen becomes domiciled in Germany, he will continue to be treated as a resident of the United States for a period of 10 years. As a result, during that period Germany may only impose situs-based taxation otherwise allowed by the Convention. This provision is reciprocal, so that a German citizen who becomes domiciled in the United States will continue to be treated as a resident of Germany for a 10 year period. By extending the time period from 5 to 10 years, the Protocol furthers the policy of preventing the interaction of the two Contracting States' transfer tax regimes from inhibiting the flow of personnel between the two States.

Article 2

In general, the Convention allows the Contracting State of which a decedent or donor was not a resident to impose transfer tax only on certain types of assets situated in that State (i.e., those assets specified in Articles 5 (Immovable Property), 6 (Business Property of a Permanent Establishment and Assets Pertaining to a Fixed Base Used for the Performance of Independent Personal Services), and 8 (Interests in Partnerships)). Article 10 (Deductions and Exemptions) specifies certain deductions and exemptions that the State in which such assets are situated must allow in exercising its right to tax under the Convention.

Paragraph 4 of Article 10 of the Convention obligates a Contracting State exercising its right to impose situs-based taxation under Articles 5, 6, or 8 to provide a marital exclusion for interspousal transfers of certain types of noncommunity property from domiciliaries or citizens of the other Contracting State. Interspousal transfers of such property may be included in the tax base of the Contracting State where the property is located only to the extent the value exceeds 50 percent of all the property that may be taxed by that State solely by reason of Articles 5, 6, or 8.

Article 2 of the Protocol amends Paragraph 4 of Article 10 of the Convention to provide that that paragraph does not apply to a citizen of the United States domiciled in Germany or to a former citizen or long-term resident of the United States referred to in subparagraph a) of paragraph 1 of Article 11 (Credits). As a result, the United States is not obligated to provide the benefits of paragraph 4 of Article 10 of the Convention to the estate of or a gift made by such a person. For example, a United States citizen who is domiciled in Germany under German law could, for purposes of the Convention, be determined to have his fiscal domicile in Germany under the tie-breaking rules of paragraph 2 of Article 4 (Fiscal Domicile). As a result of Article 2 of the Protocol, the United States is not required to provide the marital exclusion of paragraph 4 of Article 10 of the Convention with respect to interspousal transfers from that U.S. citizen to a spouse who is not a U.S. citizen. (If the spouse is a U.S. citizen, the transfer might be eligible for the unlimited marital exclusion provided under U.S. law).

Article 3

Article 3 of the Protocol adds new paragraphs 5 and 6 to Article 10 (Deductions and Exemptions) of the Convention. New paragraph 5 grants a "pro rata" unified credit to the estate of a decedent domiciled in Germany for purposes of computing the U.S. estate tax. New paragraph 6 allows a special "marital deduction" against U.S. estate tax in respect of certain transfers to a surviving spouse. Similar provisions were included in the Third Protocol to the U.S.-Canada Income Tax Treaty.

Pro Rata Unified Credit

Under the Internal Revenue Code, the estate of a nonresident not a citizen of the United States is subject to U.S. estate tax only on its U.S. situs assets and is entitled to a unified credit of \$13,000, while 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 Internal Revenue Code section 2010. For decedents dying between 1987 and 1997, the unified credit under section 2010 was \$192,800. The unified credit under section 2010 is scheduled to increase periodically from \$202,050 for estates of decedents dying during 1998 to \$345,800 for estates of decedents dying in 2006 and thereafter. (The unified credit under section 2010 for estates of decedents dying during 1999 is \$211,300.) A lower unified credit is provided for the estate of a nonresident not a citizen 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.

In appropriate cases, the pro rata unified credit provisions of new paragraph 5 of Article 10 of the Convention increase the credit allowed to the estate of a non-U.S. citizen domiciled in Germany 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. New paragraph 5 also provides that the amount of the unified credit allowed to the estate of a non-U.S. citizen decedent domiciled in Germany will in no event be less than the \$13,000 allowed under the Internal Revenue Code to the estate of a nonresident not a citizen of the United States (subject to the adjustment for prior gift tax unified credits, discussed below). New paragraph 5 does not apply to the estates of U.S. citizen decedents, whether resident in Germany or elsewhere, because such estates receive the unified credit under section 2010 of the Internal Revenue Code.

Subject to the adjustment for gift tax unified credits, the pro rata credit allowed under new paragraph 5 of Article 10 of the Convention is determined by multiplying the unified credit available to a U.S. citizen under section 2010 of the Internal Revenue Code for the year in which the decedent dies (*e.g.*, \$211,300 in 1999) 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 Germany died in 1999 and half of his entire gross estate (by value) were situated in the United States, the estate would be entitled to a pro rata unified credit of \$105,650 (provided that the U.S. estate tax

due is not less than that amount). The entire gross estate wherever situated (*i.e.* the worldwide estate, determined under U.S. domestic law) is to be taken into account in computing the denominator. For purposes of computing the numerator, an estate's assets will be treated as situated in the United States if they are so treated under U.S. domestic law. However, an estate's assets will not be treated as situated in the United States for purposes of this computation if the United States is precluded from taxing them by reason of obligations elsewhere in the treaty.

New paragraph 5 of Article 10 of the Convention restricts the availability of the pro rata unified credit in two respects. First, the amount of the unified credit otherwise allowable under new paragraph 5 is reduced by the amount of any unified credit previously allowed against U.S. gift tax imposed on any gift by the decedent. This rule reflects the fact that, under U.S. domestic law, a U.S. citizen or U.S. resident individual is allowed a unified credit against the U.S. gift tax on lifetime transfers. However, as a result of the estate tax computation, the individual is entitled only to a total unified credit of \$211,300 (for decedents dying in 1999), and the amount of the unified credit available for use against U.S. estate tax on the individual's estate is effectively reduced by the amount of any unified credit that has been allowed in respect of gifts by the individual. Pursuant to this rule, the amount of the pro rata unified credit otherwise allowed to the estate of a deceased individual under new paragraph 5 is reduced by the amount of any unified credit previously allowed with respect to lifetime gifts by that individual. Under U.S. 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 U.S. resident (as defined under the Internal Revenue Code for U.S. gift tax purposes).

New paragraph 5 of Article 10 of the Convention also conditions allowance of the pro rata unified credit upon the provision of all information necessary to verify and compute the credit. Thus, for example, the estate's representatives will be required to demonstrate satisfactorily both the value of the worldwide estate and the value of the U.S. portion of the estate. Substantiation requirements also apply, of course, with respect to other provisions of the Protocol and the Convention. However, the negotiators believed it 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.

In addition, the amount of the pro rata unified credit is limited to the amount of U.S. estate tax imposed on the estate. See section 2102(c)(4) of the Internal Revenue Code.

Marital Deduction

New paragraph 6 of Article 10 of the Convention allows a marital deduction in connection with transfers satisfying each of five conditions. First, the property must be "qualifying property." Second, the decedent must have been, at the time of death, domiciled in either Germany or the United States. Third, the surviving spouse must have been, at the time of the decedent's death, domiciled in either Germany or the United States. Fourth, 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 Germany. Finally, in order to limit the benefits of new paragraph 6 to relatively small estates, the executor of the decedent's estate is required to elect the benefits of new paragraph 6 and to waive irrevocably the benefits of any estate tax marital deduction that would be allowed under U.S. domestic law, on a U.S. Federal estate tax return filed by the deadline for making a qualified domestic trust election under Internal Revenue Code section 2056A(d). In the case of the estate of a decedent for which the U.S. Federal estate tax return is filed on or before the date on which this Protocol enters into force, this election and waiver must be made on any return filed to claim a refund pursuant to the special effective date applicable to such estates (discussed below with respect to Article 5 of the Protocol).

In order for property to be "qualifying property," it 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 been properly made. Because one of the requirements for property to qualify for the marital deduction under U.S. domestic law is that the property be included in determining the value of the gross estate, property will not qualify for the marital deduction of new paragraph 6 to the extent the property is excluded from the decedent's gross estate by reason of paragraph 4 of Article 10 of the Convention. Example 2, below, illustrates the interaction of the two provisions.

The amount of the marital deduction allowed under new paragraph 6 of Article 10 of the Convention equals the lesser of (i) the value of the qualifying property, or (ii) the "applicable exclusion amount" (within the meaning of the law of the United States, determined without regard to any gift previously made by the decedent). The "applicable exclusion amount" is determined under section 2010 of the Internal Revenue Code with respect to the year in which the decedent dies. For decedents dying between 1987 and 1997, the applicable exclusion amount was \$600,000. The applicable exclusion amount under section 2010 is scheduled to increase periodically from \$625,000 for estates of decedents dying during 1998 to \$1,000,000 for estates of decedents dying in 2006 and thereafter. (The applicable exclusion amount for estates of decedents dying during 1999 is \$650,000.)

In certain cases, the provisions of new paragraph 6 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. If, in lieu of making the QTIP election and the qualified domestic trust election, the decedent's executor makes the election described in new subparagraph 6(d), the provisions of Internal Revenue 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) will not apply. To obtain this treatment, however, the executor is required, under new paragraph 6, to irrevocably waive the benefit of any marital deduction allowable under the Internal Revenue Code with respect to the trust.

The following examples illustrate the operation of the pro rata unified credit and the marital deduction and their interaction with the marital exclusion of existing paragraph 4 of Article 10 (Deductions and Exemptions) of the Convention. Unless otherwise stated, assume for purposes of illustration that: H, the decedent, and W, his surviving spouse, are German citizens resident in Germany at the time of the decedent's death; H dies in 2000, when the unified credit under section 2010 of the Internal Revenue Code is \$220,550 and the applicable exclusion amount under section 2010 is \$675,000; all conditions set forth in paragraphs 5 and 6 of Article 10 of the Convention, as added by the Protocol, are satisfied (including the condition that the executor waive the estate tax marital deduction allowable under U.S. domestic law); no deductions are available under the Internal Revenue Code in computing the U.S. estate tax liability; there are no adjusted taxable gifts within the meaning of Internal Revenue Code section 2001(b) or 2101(c); and the applicable U.S. domestic estate and gift tax laws are those that were in effect on the date the Protocol was signed.

Example 1. (i) 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 German situs property.

(ii) Pursuant to paragraph 4 of Article 10, the U.S. gross estate equals \$1,000,000 (the amount by which the \$2,000,000 of U.S. real property bequeathed to W exceeds \$1,000,000 (50% of the total value of U.S. property taxable by the United States under the Convention)). H's worldwide gross estate equals \$4,000,000 (\$1,000,000 plus \$3,000,000 of German situs property).

(iii) The \$1,000,000 U.S. gross estate is reduced by the \$675,000 marital deduction of new paragraph 6 of Article 10, resulting in a \$325,000 U.S. taxable estate. The tentative tax on the taxable estate equals \$96,300. H's estate would also be entitled to the pro rata unified credit allowed by new paragraph 5 of Article 10 of \$55,138 ($\$220,550 \times \frac{\$1,000,000}{\$4,000,000}$ (the \$1,000,000 U.S. gross estate divided by the \$4,000,000 worldwide gross estate)). Thus, the total U.S. estate tax liability is \$41,162 ($\$96,300 - \$55,138$).

Example 2. (i) The facts are the same as in Example 1, except that H bequeaths \$600,000 of his U.S. real property to W and \$1,400,000 of his U.S. real property to C, H's child.

(ii) The \$1,400,000 of U.S. real property bequeathed to C is included in H's U.S. gross estate. Pursuant to paragraph 4 of Article 10, none of the U.S. real property bequeathed to W is included in the gross estate, because such property would be included only to the extent its value (i.e., \$600,000) exceeded 50% of the \$2,000,000 total U.S. situs property taxable under Articles 5, 6 or 8 of the Convention. H's worldwide gross estate equals \$4,400,000 (\$1,400,000 plus \$3,000,000 of German situs property).

(iii) Because none of the U.S. situs property bequeathed to W is included in the U.S. gross estate, the property is not "qualifying property", and therefore no marital deduction is allowed with respect to that property under new paragraph 6 of Article 10. The tentative tax on the \$1,400,000 gross estate equals \$512,800. H's estate would also be entitled to the pro rata unified

credit allowed by new paragraph 5 of Article 10, which equals \$70,175 (\$220,550 (the full unified credit), multiplied by a fraction equal to the \$1,400,000 U.S. gross estate over the \$4,400,000 worldwide gross estate). Thus, the total U.S. estate tax liability is \$442,625 (\$512,800 - \$70,175).

Article 4

Article 4 of the Protocol amends the “saving” clause of paragraph 1 of Article 11 (Credits) of the Convention. Pursuant to the saving clause, the Contracting States reserve their rights, subject to certain exceptions, to tax certain estates or donors as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary.

Prior to the amendment made by the Protocol, the United States reserved the right to tax under its domestic law the estate or gift of a U.S. citizen. The United States also retained its right to tax, for a 10-year period, a former citizen who renounced his citizenship with a principal purpose of tax avoidance.

Article 4 of the Protocol retains the United States’ right to tax the estates or gifts of these classes of individuals. In addition, it expands the saving clause to cover two additional classes of individuals. First, the United States retains the right, subject to certain exceptions, to tax the estate of a decedent or the gift of a donor who, at the time of his death or at the making of the gift, was domiciled (within the meaning of Article 4 (Fiscal Domicile) of the Convention) in the United States. Second, the United States retains the right, subject to certain exceptions, to tax the estate of a decedent or the gift of a donor who, at the time of his death or at the making of the gift, was a former long-term resident of the United States whose loss of such status had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

The provision regarding former long-term residents is intended to reflect 1996 amendments to sections 877, 2107, and 2501(a)(3) of the Internal Revenue Code, which allows the United States to tax such former long-term residents for a period of 10 years in a manner similar to the taxation of former citizens who expatriated with a principal purpose of tax avoidance. The Protocol provides that 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, which would include, for example, the presumptions based on average annual net income tax liability and net worth under section 877.

Some provisions of the Convention and Protocol are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 1 of Article 11 of the Convention sets forth certain exceptions to the saving clause that preserve certain obligations of the Contracting States under the Convention. Article 4 of the Protocol adds exceptions to the saving clause with respect to paragraphs 5 and 6 of Article 10 (Deductions and Exemptions). These paragraphs, which were added by Article 3 of the Protocol, provide a pro rata unified credit and a marital deduction, respectively. These exceptions to the saving clause do

not apply, however, to former U.S. citizens or long-term residents whose loss of citizenship or residence status had as a principal purpose the avoidance of tax, for a period of 10 years following such loss. Although the pro-rata unified credit generally is an exception to the saving clause, by its terms it does not apply to estates of U.S. citizens, which are entitled to the full unified credit pursuant to internal U.S. law.

Article 5

This Article specifies the procedure for bringing the Protocol into force and the effective dates of the provisions of the Protocol. The Protocol is subject to ratification in accordance with the applicable procedures of each Contracting State, and will enter into force upon the exchange of instruments of ratification.

Pursuant to Paragraph 2, the Protocol generally will have effect with respect to deaths occurring and gifts made after the date on which the Protocol enters into force (i.e. the date on which the instruments of ratification are exchanged).

Paragraph 3 contains special retrospective effective date provisions for Articles 3 and 4 of the Protocol. Articles 3 and 4 of the Protocol will take effect with respect to deaths occurring and gifts made after November 10, 1988. However, the benefits of those provisions will be available to estates of decedents whose deaths occur or have occurred after November 10, 1988, and prior to the general effective date of paragraph 2, only if a claim for refund due as a result of these provisions is filed by the later of one year from the date on which the Protocol enters into force or the date on which the applicable period for filing such a claim expires under the domestic law of the Contracting State concerned.