German-American Tax Law

Estate Taxation of Nonresident Germans in the U.S.

This article provides a brief introduction to the taxation of estates of nonresident Germans under the German-U.S. Treaty for the Avoidance of Double Taxation with respect to taxes on estates, inheritances and gifts.

Jerome Synold, Attorney-At-Law
Jan-Hendrik Frank, German Attorney-At-Law

The "Convention between the Federal Republic of Germany and the United States of America for the Avoidance of Double Taxation with respect to taxes on estates, inheritances, and gifts The Federal Republic of Germany and the United States of America" (the "Treaty") provides non-resident Germans with beneficial treatment and estate planning techniques otherwise not available to nonresident aliens subject to situs based treaties This articles provides a brief overview of non-resident taxation in the U.S. and concludes with an application of the U.S.-German treaty.

Overview of the national U.S. Estate and Gift Taxes as Applied to Nonresident Aliens

U.S. estate and gift taxes are applied based on domicile and situs. This section analyzes the tests used by the I.R.S. to determine the application of estate and gift taxes on non-resident aliens.

Domicile

The I.R.S imposes estate and gift taxes on individuals deemed to be residents of the U.S. An alien is characterized as a resident if he or she is domiciled within the U.S. at the time of death.

The test for domicile can result in unanticipated consequences. For example, an alien who enters the U.S., for even a brief period of time, with no definite present intention of leaving is deemed to be domiciled in the U.S. and would be considered a resident for U.S. estate and gift tax purposes.

Confusingly, the I.R.S utilizes somewhat different tests to determine residency for income tax purposes. Such tests include the "substantial presence test" or "Green Card test". Accordingly, an individual could be deemed a resident for purposes of the estate tax under the extremely subjective domicile test while characterized as a non-resident for income tax purposes based on the more rigid "substantial presence test"

The domicile test is fact based and extremely subjective. The goal of the test is to characterize persons as domiciled in the U.S. when that individual enters the U.S. with no present intention of later leaving. As these taxes are typically applied to deceased individuals, practitioners, courts and I.R.S. representatives are left to determine from whatever limited evidence remains whether the individual was domiciled in the U.S. at the time of death. The test is factually based and considers many factors, however, none of the factors are determinative and the weight each factor receives is unclear. The factors include:

(i) the length of time spent in the U.S. and abroad and the amount of travel to and from the U.S. and between other countries;
(ii) the value, size, and locations of the donor's or decedent's homes and whether he or she owned or rented them;
(iii) whether the alien spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc.;
(iv) the situs of valuable or meaningful tangible personal property; (v) where the alien's close friends and family are situated;
(vi) the locales in which the alien has religious and social affiliations or in which he or she partakes in civic affairs;
(vii) the locales in which the alien's business interests are situated;
(viii) visa status; (ix) the places where the alien states that he or she resides in legal documents;
(x) the jurisdiction where the alien is registered to vote;
(xi) the jurisdiction that issued the alien's driver's license; and
(xii) the alien's Income tax filing status.

Assets Subject to U.S. Estate and Gift Tax

If a non-resident alien fails to meet the domicile test described above he or she will generally only be subject to federal estate taxes based on U.S. situs property. As typical with U.S. bilateral estate and gift tax treaties, U.S. situs property includes real property and other tangible personal property physically located in the U.S. as well as shares of stocks issued by U.S. corporations. While gifts of U.S. situs intangible property by non-resident aliens are generally exempt from gift taxes.

Deductions of Debts

Without the application of the U.S.-German treaty, an alien resident is limited to minimal deductions that include a portion of the expenses, losses, indebtedness, and taxes set forth in Code Sections 2053 and 2054. These deductions are limited to funeral and administration expenses, claims against the estate, mortgages on, and indebtedness with respect to, property included in gross estate, and uninsured casualty losses suffered by the estate. The deductible portion of the expenses is determined by multiplying the expenses by a fraction, the numerator of which is the value of gross estate situated in

the United States, and the denominator of which is the value of all property, wherever situated, included in the gross estate.

Whether the deductible amounts were incurred in the U.S. is irrelevant for purposes of the deduction. Thus, a property note secured by a mortgage on U.S. situs property is only partially deductible, despite the fact that the market value of mortgaged property is included in full. However, this unusual application is qualified by the fact that if the property is subject to a mortgage as to which the mortgagor has no personal liability, only the value of the property less the mortgage or indebtedness is included in the gross estate, thereby effectively resulting in a deduction for 100% of the mortgage.

„ a property note secured by a mortgage on U.S. situs property is only partially deductible, despite the fact that the market value of mortgaged property is included in full. “

Estate and Gift Tax Credits

The estate of a nonresident alien receives a minimal credit of only $13,000 against the federal estate tax, which is effectively the equivalent of a $60,000 exemption. There is no credit for gifts made during the lifetime of a nonresident alien. Nonresident aliens do, however, receive the benefit of the so-called annual exclusion from gifts, which is currently $12,000 per donee.

Maritial exemption

The estate of a nonresident alien may deduct from the gross estate the value of property passing to the decedent’s surviving spouse, to the same extent that as the estate of a resident alien or U.S. citizen. Accordingly, the U.S. citizen spouse of a nonresident alien will trigger the marital deduction if all of the requirements of Code § 2056 (covering bequests to surviving spouse) are satisfied.

Should the surviving spouse not be a U.S. citizen (regardless of U.S. residency), as with the estate of a resident alien or U.S. citizen, in order for the estate of the nonresident alien to take advantage of the marital deduction, the provisions of Code § 2056(d) must be satisfied. Specifically, Code § 2056(d) provides that a bequest to a surviving spouse will not qualify for the marital deduction unless the property is held in a qualified domestic trust, as provided in Code § 2056A, or unless the surviving spouse becomes a U.S. citizen within a specified period of time after the decedent’s death. In addition, the gift tax marital deduction is generally not allowed for property passing to a spouse who is not a U.S. citizen, save for the fact that a donor can give his or her non-U.S. citizen spouse up to $100,000 per year (indexed for inflation)without the imposition of any gift tax.

Impact of the German-US Treaty

The German-US Treaty intends to eliminate double taxation and modifies and clarifies domestic law applicable to the estate and beneficiaries with respect to inheritance and gift taxes. Accordingly, those estates and beneficiaries covered by the U.S.-German treaty receive relatively beneficial treatment.

Application of the U.S.-German Treaty

The U.S.-German treaty applies to the estates of deceased individuals domiciled at the time of death within the U.S. or Germany. The U.S.-German treaty applies to federal estate tax and the federal gift tax, including the tax regimes applicable to generation-skipping transfers. However, the U.S.-German treaty does not limit the states to impose inheritance tax.

Avoidance of double taxation because of double Domicile under the U.S.-German Treaty

Double taxation may result from the fact that different countries have different definitions of the domicile of a person. As outlined above, under U.S. law, an alien is characterized as a resident if he or she is domiciled within the U.S. at the time of death and an alien who enters the U.S. for even a brief period of time, with no definite present intention of leaving is deemed to be domiciled in the U.S. and would be considered a resident for U.S. estate and gift tax purposes. Under German law, a person is deemed to be domiciled in Germany if he or she has his or her domicile or habitual abode in Germany, or if he or she is deemed for other reasons to be subject to unlimited tax liability for the purposes of the German inheritance tax.

Under the U.S.-German treaty, domicile is determined under a somewhat different test. Under the U.S.-German treaty, if an individual owns more than one house, domicile is deemed to be in the State in which the individual’s personal and economic relations are closest. Thus, in relation to the U.S., the risk of having a nexus to Germany is far lower. However, situs taxation in Germany remains a significant issue as the tax free amount in case of situs taxation is only EUR 2,000.

Dual domicile, “tie-breaker” rules

If an individual is deemed to be domiciled in both countries under the above rules, the U.S.-German treaty “tie-breaker” rule will apply: the individual who has dual domicile will be deemed to be domiciled in the country where he or she has a permanent home, or if he or she has a permanent home in both countries or neither country, in the country where his or her personal and economic relations are the closest (“center of vital interests”). On the occasion that it cannot be determined where his center of vital interests is the closest, he will be deemed to be domiciled in the country in which he has a habitual abode and if he has habitual abodes in both countries or neither

country, he will be deemed to be domiciled in the country of which he is a citizen.

Assets Subject to U.S. Estate and Gift Tax under the German-US Treaty

As we have seen above, the U.S. taxes certain assets of nonresident aliens. The U.S.-German treaty improves the status of an alien domiciliary of Germany. Under the U.S.-German treaty, only the following assets of an alien domiciliary of Germany can be taxed by the U.S.: immovable property, business property of a permanent establishment, ships and aircraft and interest in partnerships. Any other property of an alien domiciliary of Germany can only be taxed by Germany. Such property includes cash, tangible personal property, debt obligations situated in the U.S. and shares of stock in U.S. corporations

Deductions of debts under the U.S.-German Treaty

With certain qualifications, generally the U.S.-German treaty allows for direct deductions of debts that relate to the property owned by an alien resident of the U.S.-German treaty country that may be taxed by the U.S. under the U.S.-German treaty. This places alien residents of Germany in a much better position with respect to deductions than an alien resident of a non-treaty country who, as discussed above, may only deduct a fraction of the debts based on the value of his or her U.S. situs property to the value of his or her worldwide property.

Maritial Exemption

The U.S.-German treaty provides benefits with respect to property passing to an alien's surviving spouse that are not available for other nonresident aliens. Property which passes to the spouse from a decedent or donor who was domiciled in or a citizen of one of either Germany or the U.S., which is subject to situs taxation under the German-US treaty, is included in the taxable base only to the extent its value (after deductions) exceeds 50% of the value of all property which may be taxed under the German-US treaty. However, this shall not result in a reduction of the tax due in the U.S. below the tax that would be due by applying to the taxable base determined under that sentence the rates applicable to a person domiciled in the United States of America.
Additionally, the U.S.-German treaty provides, that for determining the estate tax imposed by the U.S., the value of the decedent's taxable estate is determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes to the decedent's surviving spouse and that would qualify for the estate tax marital deduction under the law of the U.S. if the surviving spouse were a citizen of the U.S. The marital deduction is determined by the date of death and the "applicable exclusion amount." The amount of the deduction is the lesser of 1) the value of the qualifying property, or 2) the "applicable exclusion amount." The applicable exclusion amount for estates of decedents dying during 2013 is $5.25 million. The following example illustrates the marital deduction:

Example. X is a German citizen residing in Germany at the time of his death. X dies with U.S. real estate worth $2million all of which he bequeaths to his wife, Y, a German citizen and resident. The remainder of the decedent's estate is $3million of assets with a German situs. The gross estate of the decedent is calculated pursuant to Article 10(4) of the German-US Treaty and the gross estate equals $1million (the amount by which the $2million of U.S. real estate exceeds $1million or 50% of the total value of the U.S. property taxable by the U.S.). X's worldwide gross estate would be $4million.
The $1million U.S. gross estate is reduced by the marital deduction of $5.25 million resulting in no U.S. taxable estate.

Estate and Gift Tax Credits under the U.S.-German Treaty

Under the U.S.-German treaty as amended by the German-US Protocol, the estate of an alien decedent who was domiciled in the foreign country at the time of his or her death is granted a unified credit against the U.S. estate tax equal to the greater of:
a) the amount that bears the same ratio to the credit allowed to the estate of a US citizen under the US law as the value of the part of the decedent's gross estate that at the time of the decedent's death is situated in the US bears to the value of the decedent's entire gross estate wherever situated; or
b) the unified credit allowed to the estate of a nonresident not a citizen of the United States of America under the law of the United States of America.
Thus, if a non-U.S. citizen domiciled in Germany died in 2012 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 $ 2.625.000 (2012).

Jan-Hendrik Frank, Rechtsanwalt und Fachanwalt für Erbrecht

frank@wf-inter.com

Jerome Synold, Attorney-At-Law

synold@wf-inter.com