THE (NON) RECOGNITION OF TRUSTS IN GERMANY

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Tags
Estate Planning
Germany
Trusts

Germany is a civil law jurisdiction that does not recognize common law trusts. From a German perspective, it is hard to understand that ownership in strict law may rest with the trustees, while ownership in equity rests with the beneficiaries.

As there are manifold reasons for using a trust, the concept does not have one single civil law equivalent. Amongst others, one popular alternative to the common law trust is the private foundation. In Germany, a private foundation can be structured either as a corporate body with legal personality or as a separate estate without legal personality. In the latter case, ownership of the foundation's assets is held by an administrative body. This body is contractually obliged to administer the assets in accordance with the foundation's aims, thereby enabling the foundation to closely resemble the structure of a trust.

Bearing this in mind, it is not surprising that the same rules apply to the taxation of foreign trusts and foreign private foundations. But before looking on the taxation of a foreign trust in Germany, a few aspects of relevant civil and private international law should be summarized.

CIVIL LAW AND PRIVATE INTERNATIONAL LAW

Estate Planning for German Nationals

As of date of this publication, a German national cannot be a settlor of a testamentary trust because the German rules regarding conflicts of law lead to the application of German inheritance law whenever the deceased is a German national. German inheritance law, in turn, does not allow for a bequest in favor of a trust.

However, the advent of the European Succession Regulation changes the outcome.[1] If the decedent dies after August 16, 2015, the succession laws of the decedent's last habitual residence will apply. It does not matter where the habitual residence was located, and it can be inside or outside the European Union. This means that from August 17, 2015, a German national who is habitually resident in the U.S. can settle a testamentary trust, even from a German perspective, because the succession laws of the respective U.S. state will be applicable unless the testator made a testamentary choice of law in favor of German inheritance law. Inter-vivos trusts are not affected by the advent of the European Succession Regulation because a German national has always been free to settle an *inter-vivos* trust.

Transferring German Assets to a Trust

A general restriction applies to the transfer of assets to a trust: Although German

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[1] Regulation (E.U.) 650/2012.

nationals can settle foreign trusts, German situs property cannot be placed directly into trust. Germany has not ratified the Hague Trust Convention, and there are no current proposals to do so. Consequently, a foreign trust cannot directly hold German real estate or an interest in a German corporation or partnership, and the trust, as such, cannot be registered in the German land or companies register. For an individual wishing to place German assets into trust, the most straight-forward solution is for the trust to hold all the shares of an underlying foreign holding corporation that will hold the title in the German assets. Such a corporation can be registered in the land or companies register and can therefore hold the title to the German assets. From a German civil law perspective it makes no difference whether the corporation is located onshore or offshore.

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Asset Protection

Several restrictions in German private law should be considered when a trust is used for assets protection purposes.

According to German forced heirship rules, spouses and direct descendants, or in their absence, parents, have a claim for a compulsory share of a decedent's estate. If a settlor dies within ten years after settling a trust, the assets transferred into that trust will form part of the estate for forced heirship purposes. This compulsory share decreases by one-tenth for each year that passes after the settlement of the trust. The ten-year period does not start, however, if the settlor retains a usufruct right or some form of economic interest in the trust funds or if the settlor can revoke the trust at any time.

If a marriage ends in divorce, German matrimonial property law provides that the statutory regime leads to a monetary equalization of assets between the spouses, in favor of the spouse with the lower gain. Funds transferred into a trust are included in the computation of assets. In other words, transferring funds into a trust generally does not lead to a reduction in the equalization claim. Exceptions apply if the settlement of the trust occurred more than ten years prior to the divorce or if the other spouse agreed to the transfer of the funds into trust.

Generally, all gratuitous transfers, which include transfers into a trust without consideration, can be challenged by any creditor within a four-year period or within a ten-year period if the transfer is made in order to disadvantage creditors. However, it is up to the applicable jurisdiction of the foreign trust to determine whether a German judgment in favor of creditors will be enforceable against the trust when the assets are located outside of Germany.

TAXATION

Several civil law jurisdictions, such as Malta and Switzerland, that have enacted comprehensive rules on the taxation of trusts. This is not true of Germany. Singular rules can be found in the Gift and Inheritance Tax Act and in the Foreign Tax Act, which includes the German rules regarding controlled foreign corporations ("C.F.C.'s"), but there is no comprehensive tax framework on trusts. Consequently, unexpected results may occur if the settlor or beneficiary is or becomes a German tax resident.

Recognition of the Trust for Tax Purposes

Wherever special rules do not exist, German law attempts to treat trusts like comparable civil law instruments. The first question is always whether a trust should be recognized for German tax purposes. The answer depends on the facts of each individual case. If a trust is not recognized for German tax purposes, the (beneficial) ownership of the assets, for such purposes, remains with the settlor. There is no court authority specifically addressing the recognition of trusts. It is the view of the author that the principles established by the German Federal Fiscal Court, the *Bundesfinanzhof* ("BFH"), in a 2007 decision involving a Liechtenstein foundation can be equally applied to trusts. The BFH is the highest German tax court.

The principles that the BFH applied are similar to the concept of "alter ego trusts," where beneficial ownership of trust assets remains with the settlor. In the U.K., the application of this concept to facts before a court may support the contention that a particular trust is a sham. In the 2007 case, the BFH concluded that the founder retained so much control over the foundation and its assets that he could access the foundation's assets as if he were the owner. The foundation did not become the economic owner of the assets as the rights of ownership were not enforced by the legal title holder.

This conclusion was based on the following facts:

- The founder did not lose influence in the foundation (*i.e.*, he retained the right to revise or revoke the articles of the foundation);
- The foundation had a managing director who was bound by an engagement letter with the founder, obliging him to act only upon instruction by the founder and to resign upon request by the founder; and
- All rights in the foundation's assets remained with the founder as the assets could revert to the founder at his sole discretion.

Transparent Versus Opaque

For the purposes of this article, a trust that is not recognized for German tax law purposes will be called a "Transparent Trust." If the settlor has less control over the trust and its assets so that the trust is recognized for tax purposes, it will be referred to as an "Opaque Trust." An Opaque Trust is treated like a family foundation, *i.e.*, it is treated as a corporate body, which has no shareholder, and therefore is formed for a purpose and not for the benefit of any owner. There is no bright-line rule to define a trust as transparent or opaque. The determination is made on a case by case basis in light of all the facts and circumstances, which explains the uncertainty faced when working with trusts. In theory, it might be quite simple to ensure that a trust is seen as opaque. But in most cases, the settlor is not willing to give away complete control of the assets and the trust, making it difficult to determine if the level of control retained makes the trust transparent. In any event, a Transparent Trust could become an Opaque Trust if it becomes irrevocable after the settlor's death.

Settlement of a Trust

The settlement of an Opaque Trust and the transfer of assets to an Opaque Trust are subject to German Gift and Inheritance Tax ("G.I.H.T."). G.I.H.T. applies if the settlor (i) is a German tax resident or (ii) is a German national whose residency or habitual abode was located in Germany at some point during the most recent five years before settling the trust. If the German national is a U.S. resident, the look-back period is extended from five years to ten years. The tax rate is 30% on transfers below €6 million. Above that amount, a tax rate of 50% applies. Because all gifts made within a period of ten years are aggregated, making several separate transfers to a trust will not reduce the tax rate.

To the extent a transfer of assets to a trust is permitted, the transfer of assets to a Transparent Trust does not trigger G.I.H.T because economic ownership remains with the settlor. However, when the trust transfers property to an underlying company, the risk of G.I.H.T. is quite high. Even if the trust is transparent, the foreign corporation will be opaque for G.I.H.T. purposes and that transfer is taxable.

Death of the Settlor

In the case of a Transparent Trust, the assets remain with the settlor and form part of the settlor's estate. Consequently the death of the settlor triggers G.I.H.T. if the settlor is a German tax resident. If a trust is opaque and qualified as a corporate body, it is not affected by the death of the settlor. Remember, the settlor is not considered to be the owner of an Opaque Trust and so the assets of the trust are not subject to inheritance tax.

From an estate planning perspective, it is usually preferable to structure an *inter-vivos* trust as opaque. No one can foresee the applicable tax law at the time of the settlor's death, and while transferring assets to an Opaque Trust will trigger G.I.H.T. directly, it is a foreseeable consequence that can be planned for appropriately.

Changes in the Class of Beneficiaries

Changes in the class of beneficiaries do not lead to tax consequences in Germany, regardless of the trust's status as opaque or transparent.

Trust Income

If a trust is a Transparent Trust, all its income is considered to be the income of the settlor for German tax purposes. If the settlor is a German tax resident, the worldwide income of the trust is subject to the settlor's personal income tax liability in Germany, as limited by the relevant double tax treaties. For the purpose of applying the provisions of a double tax treaty the settlor is the relevant person.

If the trust is an Opaque Trust, the trust itself will be neither a German tax-resident, nor the direct owner of German situs property. Therefore, the trust will not be subject to tax in Germany. Again, income from German situs property owned by a foreign corporation owned by the Opaque Trust will be subject to corporate income tax in Germany.

Even if the trust itself is not subject to German income tax, the Foreign Transactions Tax Code ("F.T.T.C."), *i.e.*, the German C.F.C. rules, may attribute that income to a German resident. Section 15 of the F.T.T.C. provides that earnings of a family trust are attributed to a German-resident settlor or proportionally to the German tax-resident beneficiaries if the settlor is not a German tax resident. A trust is qualified as a family trust if the settlor, persons associated with the settlor, and the descendants of each are entitled to more than half of the trust benefits. According to the German tax authorities, such entitlement need not be legally enforceable. Even if a trust is fully discretionary, it will be qualified as a family trust if more than half of the beneficiaries are family members. This rule applies even if no distributions were made in the past. The attribution of profits to a German resident leads to German income tax liability, even if there has been no distribution of cash or assets to the beneficiaries. On the other hand, a previously taxed income concept applies to income of the trust that has already been attributed to a German resident and taxed. When distributed to German resident beneficiaries, the distribution is free of German income tax, provided the distribution occurs within seven years after the attribution of income.

The general policy of profit attribution is to apply German tax rules to the trust income as if the German tax resident had received the profits directly. Nevertheless, it often leads to a heavy tax burden. One practical example arises when trust assets are invested in U.S. or other foreign investment funds. In Germany, investment funds must file certain tax information in an official Federal bulletin. The failure to file – as is the case with nearly all funds not designed for the German market – results in the application of a special tax regime calling for a minimum annual tax of 6% of the fund's net asset value. This tax applies even in years the fund has made a loss.

In 2014, the European Court of Justice ruled that this special regime does not comply with the fundamental freedoms of the European community.[2] The taxpayer must be granted the opportunity to prove the amount of the actual profit, if one was made, or existence of an operating loss. The former may reduce the tax and the latter may eliminate the tax. A letter ruling published by the Federal Ministry of Finance now allows the taxpayer to bring evidence of actual profits, but the requirements set out in the letter ruling are extensive. Even if the German tax resident is able to obtain all the information from the relevant foreign fund, a substantial compliance cost will be incurred.

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German beneficiaries must file a separate tax declaration for the trust in which income of the trust is computed in accordance with German tax rules. Again, compliance costs are substantial.

Trust Distributions

Trust distributions made from a Transparent Trust are treated as direct payments from the settlor (*i.e.*, the economic owner) to the beneficiaries. Typically, the distributions are made without the receipt of consideration. Consequently, the distribution will be treated as a gift by the settlor. If the settlor or the beneficiary receiving the distribution is a German tax resident, the distribution is subject to G.I.H.T., which is imposed at a rate that ranges between 7% and 30% for direct relatives. The exact rate depends on the value of the distribution and any other gifts made during the previous ten years.

Trust distributions from an Opaque Trust will face a high level of uncertainty in Germany. One source of this uncertainty is a decision by the BFH made in 2013 in which the Court ruled that all payments made out of a trust are subject to G.I.H.T. But the decision seems to ignore specific provisions of German tax law. There are two different provisions applicable to distributions from a trust. The Income Tax Act provides that distributions from foreign foundations and trusts are taxed as income from capital similar to dividends. In addition, the G.I.H.T. act provides that all payments made from a foreign fund with or without legal personality during its existence

[2] *Rita van Caster and Patrick van Caster v. Finanzamt Essen-Süd*, C-326/12.

are subject to G.I.H.T. This wording applies to trusts, but not to family foundations. Without any further differentiation, this would mean that the same distribution is subject to G.I.H.T. and income tax at the same time, leading to a total tax burden of up to 75%.

Systematically, this should be impossible. The income tax applies to income of the taxpayer. On the other hand, the G.I.H.T. applies to the enrichment resulting from a gratuitous receipt of assets. In principle, a distribution is either income or gratuitous enrichment. Nonetheless, the BFH has ruled in the past that income tax and G.I.H.T. could be applied side by side. In recent cases. the BFH has moved towards a more systematic approach, *i.e.*, levying either income tax or G.I.H.T. But there still is no settled case law in Germany.

For foreign foundations, this conflict appears to have been resolved. If a distribution from a foundation is based on its articles, such distribution is not "without consideration" and, therefore, is subject to German income tax but not G.I.H.T. Conversely, if the foundation makes a distribution that is not based on its articles or if the foundation's assets are distributed, such distributions are subject to G.I.H.T. but not income tax.

For trusts, the BFH denied this differentiation and ruled that all distributions made by a trust are subject to G.I.H.T. The language of the law allows for such an interpretation, especially since the relevant wording in the G.I.H.T. act is applicable only to trusts, not to family foundations. The author believes there is no reason to apply different rules to opaque family trusts and family foundations. Recent changes in law have eliminated loopholes that may have existed at one time and there is no longer a reason for a trust distribution to be subject to income tax and G.I.H.T.

Nonetheless, as of today, distributions made from an Opaque Trust to a German resident beneficiary are subject to both G.I.H.T. and German income tax.

<u>Revocation of a Trust</u>

The revocation of a Transparent Trust has no tax consequences since from a German tax perspective ownership of the trust assets remains with the settlor. Therefore, revocation does not result in a transfer of these funds.

In contrast, the revocation of an Opaque Trust will lead to a transfer of the assets held in the trust to the settlor without consideration. This triggers again – as with the settlement – G.I.H.T. at a rate of 30% on assets up to €6 million and 50% on assets above €6 million.

SUMMARY

Although trusts are unknown to German civil law and Germany has not ratified the Hague Convention on Trusts, trusts can be used for estate planning purposes, even if German tax residents are involved. However, this requires very careful planning in each individual case. Because of the high risk of double taxation of trust distributions and a resulting tax burden of up to 75%, trusts should primarily be used as savings boxes where German tax residents are involved. If a trust is settled by a non-German tax resident and structured correctly with a view to the F.T.T.C. rules, such a trust could be used to avoid German taxes, particularly if a beneficiary resides in Germany on a temporary basis.