THE IMPACT OF BREXIT ON GERMAN TAXES FOR PRIVATE CLIENTS AND NONPROFIT ORGANIZATIONS

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INTRODUCTION

On March 29, 2017, the U.K. informed the European Council of its intention to leave the E.U. and began the exit process by invoking Article 50 of the Lisbon Treaty. The U.K. was scheduled to depart from the E.U. following the passage of a two-year notice period. However, as no agreement has been reached between the E.U. and the U.K., the departure date is now postponed until October 31, 2019.

Whether the E.U. and the deeply divided U.K. will reach a withdrawal agreement ("soft Brexit") by the extended deadline is anything but certain. There have been several failed attempts and no consensus exists within the U.K. If no agreement is reached on a regulated withdrawal and the E.U. rejects a further postponement, the result will be a "hard Brexit."

The key concern of a hard Brexit is that all tax privileges enjoyed by E.U. Member States will cease to apply to the U.K. as of the departure date. Nevertheless, grandfathering will maintain the status quo for taxpayers, as long as all tax-relevant actions are completed before Brexit. Brexit itself should not cause the creation of a retroactive tax liability on completed transactions. In comparison, if a withdrawal agreement is reached, there will be no relevant changes in the status of the U.K. within the E.U. until a phase-out period is completed. The U.K. will be treated as a Member State until the end of the phase-out.

The German legislature has not waited to act with regard to the forthcoming changes. For the different scenarios, laws have been passed to take into account the tax problems that could arise. The Tax Accompanying Act (*Brexit Steuerbegleitgesetz*) and the Brexit Transitional Act (*Brexit-Übergangsgesetz*) are of particular importance.

This article provides an overview of the consequences of a departure by the U.K. in a hard Brexit and a soft Brexit.

CONSEQUENCES OF LEAVING WITHOUT AN AGREEMENT

U.K. Relapse into Non-Member State Status

If an agreement is not concluded or postponement of the withdrawal fails, the U.K. will cease being an E.U. Member State after October 31, 2019. The E.U. fundamental freedoms will cease to apply and all E.U. or E.E.A. entitlements to tax benefits will terminate. German law will not provide unilateral rules to mitigate the consequences of Brexit as far as post-Brexit transactions are concerned.

Consequences for U.K. Nonprofits and Their Donors

In the past, non-German not-for-profit entities encountered difficulty in meeting the requirements for tax exemptions under Section 55 et seq. of the German Fiscal Code (*Abgabenordnung*). It was difficult for a non-German entity to provide the necessary evidence to establish a civic purpose, and foreign nonprofits and their donors failed in most cases. Consequently, the practical impact of a hard Brexit is likely to be limited for foreign nonprofits.

A hard Brexit will mean that nonprofits from the U.K., which are currently subject to limited tax liability, (in particular charities under English law) will no longer be exempt from German corporation tax. At the same time, donors will no longer be able to deduct charitable donations from their taxable income, and there is an increased risk that donations will be subject to gift taxes. In addition, the carrying value privilege will no longer be in effect when an asset is withdrawn and transferred to a charitable organization in the U.K. Under this privilege, the transfer of assets will not trigger recognition of hidden reserves equal to the difference between fair market value and the carrying value on the books of the transferor. Instead, the transfer and the donation will both be measured according to the carrying value plus V.A.T. The transfer will be valued at fair market value, hidden reserves will be triggered, and no deduction will be allowed.

Example 1

Facts: German company A-Co decides to transfer its current inventory of computers to an English nonprofit.

Result: Theoretically, before Brexit, the computers could be withdrawn at the carrying value, provided the nonprofit could prove its entitlement to a tax exemption. Hidden reserves would not be taxed and the donation would equal to the carrying value (plus V.A.T.). After Brexit, the withdrawal can only take place at partial value and no deduction would be allowed for the donation when computing taxable income.

In addition, the annual tax allowances of €2,400 and €700 for training leaders and volunteers will not be allowed.

In the case of a hard Brexit, it will be imperative for German tax-privileged corporations that support recipient organizations in the U.K. to embed a fundraising clause in their statutes within the meaning of the Section 58, Article 1, of the German Fiscal Code in order to avoid risks under charitable law. Admittedly, this has been and still is recommended for any cross-border promotion.

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Consequences for Beneficiaries of Trusts

The German Foreign Tax Act stipulates that the income of a foreign family foundation is attributed to the founder or, alternatively, to the beneficiaries. This also applies to foreign trusts. The founder, settlor, or beneficiaries must pay tax on this income as if it were their own income.

The law provides for exceptions for family foundations or trusts established in an E.U. or E.E.A. Member State. In order for the exception to apply, proof must be provided that none of the founder, settlor, or beneficiaries control how the foundation will dispose of the assets. In addition, in the case of a non-German foundation

or trust, information must be available to German tax authorities under the Mutual Assistance Directive. This has been the case in the U.K. thus far.

After a hard Brexit, it will no longer be possible to provide proof that a trust resident in the U.K. meets the conditions for applying the exception.

Example 2

Facts: A, domiciled in Berlin, is the beneficiary of a trust resident in the U.K., which realizes dividend income from shares in U.K.-resident companies. The settlor has already passed away. A has not yet received any distributions from the trust.

Result: After Brexit, the trust income will be attributed to A and other beneficiaries, possibly *pro rata*, on the basis of the German Foreign Tax Act, even if no distributions have been made. A will be taxed on the dividends derived by the trust as if they were received by him. If A later receives distributions from the trust, he should not be taxed a second time, provided he can prove earlier taxation at the time the underlying dividends were received by the trust.

Exemption from Inheritance and Gift Tax for Transfers of Companies

German inheritance tax law provides for relief when the assets owned by the decedent are business assets used in a permanent establishment in an E.U. or E.E.A. Member State. The relief is in the form of a total or 85% exemption from the tax. Relief is also provided under German inheritance tax law for shares that represent a holding of at least 25% in a limited company that has its seat of management in an E.U. or E.E.A. Member State. In the event of a hard Brexit, these reliefs will no longer be available.

Example 3

Facts: Mother A, domiciled in Berlin, is the sole shareholder of a corporation resident in London. After she has passes away, her daughter inherits the shares.

Result: Since Mother A was domiciled in Germany, the acquisition of the shares in the English corporation by her daughter is subject to German inheritance taxation. If the life of Mother A ends after a hard Brexit, the tax exemption for business assets and for shares in corporations can no longer be claimed for the shares in the English corporation.

In addition, the value used for computing inheritance tax on rented housing in the U.K. will no longer be capped 90% of actual value. The tax base will be increased to full fair market value. The full tax exemption for a U.K. family home when a surviving spouse or children inherit the property and continue to use it as a residence will also be abolished.

Example 4

Facts: Family A (all German citizens) has been residing exclusively in England for two years and live there in a family home that is owned. Both parents die in an accident. Their son stays in the family home. He is the only heir.

Result: Since the family has not lived abroad for more than five years, the parents' estates are subject to German inheritance tax. The family home can no longer be inherited tax-free because it is not located in an E.U. Member State after Brexit.

Finally, inheritance tax exemptions for cultural goods located in the E.U. or E.E.A. will likely end in the case of a hard Brexit.

Other Regulations

Advantageous regulations regarding the relocation of a corporation's seat to an E.U. Member State will no longer be applicable. Under a hard Brexit, the relocation will be a taxable disjunction, which is the term used to describe a deemed disposition of business assets treated as a taxable event for purposes of the German Transformation Tax Act and the provision of the German Foreign Tax Act imposing exit taxation.

"Grandfathering" When All Tax-Relevant Actions Are Completed

In order to ensure that Brexit does not have any negative legal consequences for a taxpayer that has completed an exit from Germany prior to a hard Brexit, the German Tax Accompanying Act extends special transitional rules to existing situations. The aim is to maintain the status quo, but only if the taxpayer completes all relevant actions for an exit prior to the effective date of a hard Brexit.

Inheritance Relief for Business Assets

German inheritance tax law has been amended to maintain certain tax exemptions granted in the past. Under German inheritance tax law, an 85% exemption is provided for the value of business assets if the business is continued for at least five years and the cost of direct wages during the five-year period is not less than 400% of the average annual direct wages in the five-year period prior to the death of the shareholder. Complete tax exemption is allowed if, *inter alia*, the wage expense during the seven years following the date of death does not fall below 700% of the average wage expense for the seven years prior to the date of death.

The computation is made by taking into account wages incurred by subsidiary corporations or partnerships in which an ownership percentage in excess of 25% is maintained. The subsidiary or partnership computation includes companies and partnerships based in the E.U. or E.E.A.

Provided the death occurs prior to Brexit, the exemption will continue to take into account the wage base in the U.K. both before and after Brexit takes place.

Taxable Disjunction (Deemed Disposition) of Assets

If an asset is removed from the pool of business assets located in Germany and transferred to a permanent establishment in a Member State of the E.U., an adjustment item is created in the form of a hidden reserve, which must be recognized over five years in equal annual amounts. If the asset ceases to be subject to the tax authority of a Member State, the unrecovered balance must be recognized immediately, and the resulting profit is taxed at that time. The German Tax Accompanying Act prevents the deferral from being eliminated and tax liability from being triggered solely by the U.K.'s withdrawal from the E.U.

Example 5

Facts: A-GmbH, based in Germany, has transferred a special crane from its German permanent establishment to its English permanent establishment. The special crane has hidden reserves of €10,000, which must be taken into account over five years.

Result: A-GmbH can recognize the hidden reserve in €2,000 annual increments over five years. Brexit does not end the write-off over five years. Immediate tax on the unrecovered reserve is not required.

Maintenance of the Tax-Free Investment Reserve – No Interest on Tax Deferral in Case of Reinvestments in the E.U.

The advantages of a tax-free investment reserve, which is intended to promote investment in E.U. Member States, are also preserved. In principle, the German Income Tax Act stipulates that the tax due on the capital gain can be paid in five equal annual instalments upon request if the hidden reserves are transferred to certain passive assets such as real estate. However, interest must be paid if there is no reinvestment in business assets located in the E.U. or E.E.A. According to the German Tax Accompanying Act, no interest payment is due if an application for payment in instalments is filed before Brexit and the business assets are reinvested in the U.K. after Brexit.

Example 6

Facts: A-GmbH, resident in Germany, maintains permanent establishments in Germany and in England. A plot of land that has belonged to the German permanent establishment for over six years is sold at a profit. The capital gain, which is taxable in Germany, is deferred upon request. After Brexit but within the following four financial years, another property is acquired in England.

Result: The deferral of the capital gain is not terminated by Brexit. The deferral granted by the instalments does not become interest-bearing, as the application is made before Brexit and the provisions of the German Tax Accompanying Act consider reinvestment in the U.K. to be sufficient.

No Deemed Dissolution and Taxation in the Event of Departure of a Corporation Through Transfer of Management or Registered Office

In principle, a transfer of the management or the registered office of a corporation to a non-Member State results in a deemed dissolution, since no Member State of the E.U. or the E.E.A. retains the right to impose tax on the worldwide income of the corporation. An amendment to the German Corporate Income Tax Act prevents a corporation that has transferred its management or registered office to the U.K. in the past from becoming subject to subsequent taxation due to Brexit. The amendment clarifies that Brexit is not sufficient event to trigger such tax liability.

Example 7

Facts: A-GmbH has relocated its management from Berlin to London. The U.K. then withdraws from the E.U.

Result: Since the transfer of management took place when the U.K. was a Member State, no dissolution is deemed and the hidden reserves of A-GmbH are not subject to taxation. Although Brexit is associated with the exit of A-GmbH from unlimited tax liability in a Member State, it does not give rise to any tax liability due to the provisions of the German Tax Accompanying Act.

No Subsequent Exit Taxation

"If the E.U. and the U.K. reach a withdrawal agreement with a transition period, the German Brexit Transition Act . . . will allow Germany to treat the U.K. as an E.U. Member State until December 31, 2020."

If an individual departs Germany and establishes residence in a country that is not a Member State of the E.U. or the E.E.A., exit tax is imposed. The tax is deferred if the individual leaves Germany to establish residence in a Member State. The German Tax Accompanying Act prevents Brexit from triggering exit taxation on shareholdings of an individual if residence in the U.K. is established prior to Brexit.

Example 8

Facts: After 12 years in Germany, A moves his domicile back to England, his country of birth. He is the owner of various participations in domestic and foreign corporations of more than 1%. The tax office defers the tax on departure without interest and without security. After his departure, the U.K. withdraws from the E.U.

Result: Withdrawal from the E.U. does not constitute a reason for revoking the deferral. Exit tax will continue to be deferred as long as A does not, for example, sell the investments or move to another third country. If A moves his residence to the U.K. after Brexit, he must pay tax on the difference between the acquisition cost and the fair market value of the shares as a notional capital gain. If security was provided, the payment could be deferred for a period of five years, if immediate payment represents a considerable hardship for A.

Other Regulations

There are also amendments to the German Transformation and Corporation Tax Act to mitigate the adverse effects of Brexit on companies resident in the U.K. For example, retroactive taxation of capital gains will not be triggered solely by Brexit.

CONSEQUENCES OF A WITHDRAWAL AGREEMENT

If the E.U. and the U.K. reach a withdrawal agreement with a transition period, the German Brexit Transition Act will enter into force. The act will allow Germany to treat the U.K. as an E.U. Member State until December 31, 2020, if the withdrawal agreement is accepted. The tax privileges of E.U. Member States would continue to apply until then.

The German Brexit Tax Accompanying Act has already entered into force. However, the individual rules presuppose that the U.K. is no longer a Member State or is treated as such. Thus, the effects of the German Tax Accompanying Act would only be felt after the transitional period ends on December 31, 2020.

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