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TAX TREATMENT OF TRUSTS IN GERMANY

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I. Setting up a Trust

Will cause gift tax only if

- the Settlor legally and actually gets rid of all possibilities of disposing of transferred assets (§ 7 para. 1 sentence 1 no. 8 sentence 2 Inheritance Tax Act), i.e. no reservation of property or administration rights

and at the same time

- the Settlor has a residence or habitual abode in Germany or is a German citizen and has had its residence or habitual abode in Germany within the recent 5 year prior to the establishment of the Trust.

II. Nomination of Beneficiaries

- A mere nomination of beneficiaries in the Trust Deed will **not** cause any gift tax.
- A taxable gift to the beneficiary, however, may be assumed if the beneficiary is granted extensive rights to dispose of trust assets (§ 7 para. 1 sentence 1 no. 1 Inheritance Tax Act, cf. Federal Fiscal Court ruling dated 28 June 2007 – II R 21/05).

III. Death of Settlor

- Will **not** trigger inheritance tax for the beneficiary if he does not acquire extensive rights to dispose of trust assets as a result of the inheritance (§ 3 para. 1 no. 1 Inheritance Tax Act).

IV. Payouts of the Trust

- **Any** payment of profits or assets (= substance) of the Trust to domestic beneficiaries is **subject to gift tax** (§ 7 para.1 sentence 1 no. 9 sentence 2 Inheritance Tax Act, cf. Federal Fiscal Court ruling dated 27 September 2012 – II R 45/10; Fiscal Court Baden-Württemberg dated 15 July 2010 – 7 K 37/07).
- **However: Tax Class Privilege**: Favorable tax class I is applicable if the beneficiary is a descendant of the Settlor (§ 5 para. 2 sentence 2 Inheritance Tax Act; a tax rate of 30% is only applied in case of payments in excess of EUR 26 million within 10 years).

I. Transparent Trust

- If the Settlor has remained – in **economic** terms – the **owner** of the assets of the Trust (e.g. because he reserved extensive administration rights) or has transferred the position of the economic owner to the beneficiaries, the Trust will be – from a German income tax perspective – treated as transparent (§ 39 General Fiscal Code).
- Taxes on the **profits** of the Trust shall be paid in such a case either directly by the Settlor or by the beneficiary **according to general tax rules**, irrespective of whether the Trust has made distributions or not.

II. Distribution of Profits

- Profit distributions of a Trust to domestic beneficiaries are taxed at withholding flat tax rate of 26.375% (including solidarity surcharge, §§ 20 para. 1 no. 9 sentence 2, 32d para 1 Income Tax Act). If applicable, church tax is also due.
- **Problem**: Distributions of profits are thus – theoretically – subject to both gift tax and income tax!
- It is controversial whether gift tax and income tax preclude each other (so *Milatz/Herbst*, BB 2011, 1500 (1503); *Füger/v. Oertzen*, IStR 1999, 11 (15)); **double taxation** is assumed by: *Jülicher*, IStR 2002, 202 (203); *Habammer*, DStR 2002, 425 (431); *Schütz*, DB 2008, 603 (607)).
- No clear statement from revenue service and courts: **Therefore: Risk of multiple taxation!**

III. Distribution of Trust Assets

- It is not clear whether (similar to gift tax) also Trust assets (= substance) distributed to the beneficiary are subject to income tax under § 20 para. 1 no. 9 sentence 2 Income Tax Act.
- Opposing: *Desens/Hummel*, DStZ 2011, 719; *Pohl/Höhfeld*, Unternehmens- und Vermögensnachfolge, 2. Aufl. 2002, Rz. 1636).
- **Problem**: § 35b German Income Tax Act does not relieve from the burden of multiple taxation because this rule does not apply to the transfer of assets inter vivos but inter mortis successions.

III. Retention of Profits (CFC rules) - Requirements

- Under certain conditions, profit retained on Trust level is also subject to German income tax (§ 15 Foreign Transaction Tax Act):
 - Trust = **foreign** special-purpose estate, therefore § 15 para. 1 sentence 1 Foreign Transaction Tax Act is per definition applicable to every Trust
 - Settlor or at least one beneficiary has his residence or habitual abode in Germany; every future entitlement of a beneficiary will be sufficient as an indication for taxation (Federal Fiscal Court dated 25 April 2001 – II R 14/98);
 - Settlor, his relatives and their descendants must be at least at 50% beneficiaries of the Trust („Family“ Trust, similar to the term of „Family Foundation“, cf. § 15 para. 2 Foreign Transaction Tax Act)

III. Retention of Profits (CFC rules) – Legal Consequences

- If the requirements of § 15 Foreign Transactions Tax Act are met, the retained income of the Trust shall be **attributed** on a pro rata basis for the purpose of income taxation to the resident Settlor or beneficiary:
 - Such attribution shall apply to every beneficiary „**according to his share**“ in income; „share“ is often unclear because the Trust Deed does not provide for concrete distribution quotas in many cases;
 - Tax authorities tend to take the distribution policies of the Trustee in earlier years as indicator for the distribution quotas subject to taxation.
 - Even a complete discretion of the Trustee for profit distributions does not prevent from taxation in Germany, at least not in cases where the resident beneficiary has already received distributions from the Trust (Federal Fiscal Court ruling dated 2 February 1994 – I R 66/94).

III. Retention of Profits (CFC rules) – Legal Consequences

- Determination of „**Income**“ (in terms of § 2 para. 4 Income Tax Act) on Trust level (cf. § 1 para. 1 no. 5 Corporate Income Tax Act):
 - On Trust level § 8b Corporate Tax Act applies, i.e. **only 5%** of dividends and profits from the disposal of stock/shares in corporate entities are **liable to taxation**
 - **Tax authorities:** in case of a Trust holding shares in foreign corporate intermediate entities (§§ 7, 8 Foreign Transaction Tax Act) the passive income of such entities shall be directly attributed to the beneficiary having his residence in Germany (controversial)
 - Taxation of all attributed income at standard rates up to 47.475% (including solidarity surcharge, without church tax)

III. Retention of Profits (CFC rules) – Legal Consequences 2013 planned

- (failed for the time being) Annual Tax Act 2013: Determining „**Profits**“ (in terms of § 2 para. 1 Income Tax Act) on Trust level (§ 15 para. 1 sentence 1 Foreign Transaction Tax Act-DRAFT):
 - No § 8b Corporate Income Tax Act (provided, the beneficiary is an individual)
 - Taxation of all attributed income from capital assets at withholding flat tax rate of 26.375% (including solidarity surcharge, without church tax) (§ 15 para. 8 Foreign Transaction Tax Act-DRAFT)
 - Taxation of passive income from intermediate entities at standard rates of up to 47.475% (including solidarity surcharge, without church tax) (§ 15 para. 9 Foreign Transaction Tax Act-DRAFT)
 - „**Double-Trust Structures**“: Taxation of Trust income derived from another trust (§ 15 para. 10 Foreign Transaction Tax Act-DRAFT)

I. Obligation to cooperate

- Beneficiaries having their residence in Germany must report their „participation“ in a foreign trust to their local tax office if such „participation“ exceeds 10% of the Trust’s assets (§ 138 para.2 no. 3 General Fiscal Code, cf. Federal Ministry of Finance ruling dated 15 April 2010 – IV B 5 – S 1300/07/10087).
- **Problem**: unclear how to determine the quota of „participation“ – in particular with a Trust having several beneficiaries (cf. above § 15 Foreign Transaction Tax Act)
- Beneficiaries having their residence in Germany are subject to an **increased obligation to cooperate** (e.g. provide documents, exercise control rights from Trust Deed), cf. § 90 para. 2 General Fiscal Code, § 17 Abs. 1 Foreign Transaction Tax Act.
- As the case may be, obligation to report and cooperate can also apply to the Trustee (§ 35 General Fiscal Code). In certain cases, an infringement can result in the Trustee’s own tax liability (§ 69 General Fiscal Code).

II. Legal Consequences of Infringements

- Beneficiaries being legally or actually able to exercise influence on the Trustee cannot rely on having no access to information required (§ 90 para. 2 sentence 4 General Fiscal Code).
- Default of cooperation will result, as a rule, in an estimation of taxable income of the Trust (§ 162 para. 2 General Fiscal Code).
- In case the Trust has passive income from foreign intermediate entities, an amount equaling at least 20% of the fair market value of the intermediary entity is attributed to the beneficiary on a pro rata basis and subjected to income taxation (§ 17 para. 2 Foreign Transaction Tax Act).
- The means of the tax authorities to obtain information are improving: an increasingly dense network of Tax Information Exchange Agreements (TIEA) with typical trust jurisdictions

Thank you very much for your attention!



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