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Chapter 17

GERMANY

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I INTRODUCTION

Private wealth and private client law in Germany are characterised by a high number of tax and legal regulations on the one hand and a high level of judicial review on the other. Not only the civil and finance courts but also the state and federal constitutional courts ensure a consistent and proportionate application of civil law and tax law. Moreover, taxes on assets are currently low; for example, wealth tax has not been levied in Germany since 1997 (its reintroduction, however, is from time to time discussed by politicians).

Accordingly, large private assets and family-owned enterprises have been created in recent decades. Private wealth and private client law in Germany therefore primarily deals with individuals living in Germany, and German family-owned companies structuring assets in Germany and other jurisdictions.

II TAX

i Introduction

Unlimited tax liability in Germany is determined by the concept of residence for both income tax and inheritance and gift tax purposes. Residence is assessed using objective criteria. An individual is a German resident if he or she has either a permanent home[2] or a habitual abode[3] in Germany. The resident individual's worldwide income or assets are subject to income tax as well as inheritance and gift tax. The concept of domicile, however, is not recognised by German law.

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2 Section 8 of the General Fiscal Code (AO).

3 Section 9 of the AO.

With regard to income tax, there is a progressive tax rate ranging from 14 to 45 per cent. Additionally, a solidarity surcharge of 5.5 per cent of the tax due is levied. This surcharge is intended to finance the German reunification of 1990. As mentioned, income tax is levied on the worldwide income of residents. Non-residents pay tax on income from German sources (e.g., income effectively connected with a permanent establishment in Germany, income from employment in Germany (including self-employment), income from German real estate or dividends and capital gains from German companies in cases of a substantial shareholding). Non-residents do not pay income tax on non-business interest income. Income from capital investments (e.g., dividends) is subject to withholding tax at a flat rate of 25 per cent plus the solidarity surcharge; a tax treaty may allow a partial refund.

Concerning inheritance and gift tax, each beneficiary is liable for the tax on the value of his or her share of the estate received, regardless of his or her personal wealth. The inheritance and gift tax rates range from 7 to 50 per cent, depending on the relationship between the transferor and the beneficiary and the value of the share of estate received. Spouses and descendants pay inheritance and gift tax at a rate of 7 to 30 per cent. Spouses receive a personal allowance of €500,000 and a maintenance allowance of up to a maximum of €256,000. Descendants receive a personal allowance of €400,000 and an age-dependent maintenance allowance of up to €52,000. Transfers between most other relatives are taxed at a rate of 15 to 43 per cent. Between unrelated persons, the applicable tax rate is 30 or 50 per cent (for more than €6 million).

Unlimited tax liability is triggered if either the transferor or the beneficiary is resident in Germany, regardless of whether the assets received are effectively connected to Germany. If neither the transferor nor the beneficiary is resident, inheritance and gift tax is only due on certain property situated in Germany (e.g., real estate and business property). The transfer of a German bank account between non-residents generally does not trigger inheritance or gift tax.

Besides income tax and inheritance and gift tax, only a few other taxes are relevant for private clients. A transfer tax with different regional rates ranging from 3.5 to 6.5 per cent applies to the acquisition of real estate or a substantial shareholding (at least 95 per cent) in a company holding real estate. At the discretion of the relevant local authority, an annual property tax ranging from 1 to 4 per cent may be due on the value of real estate (as assessed by the local authorities). The relevant values were last assessed in 1964 or 1935. Thus, property tax is low in comparison to the property's market value. Wealth tax has not been levied in Germany since 1997.

ii Inheritance and Gift Tax Act

Since 2009, the new Inheritance and Gift Tax Act has been in force in Germany. The reform was necessary after the German Federal Constitutional Court (BVerfG) declared the former Inheritance and Gift Tax Act invalid because of the unequal evaluation of different types of assets; equality of taxation is constitutionally guaranteed in Germany. The judgment as well as the reform itself triggered extensive political debate concerning the taxation of assets, and especially of business assets. The core problem was, and still is, if and how business assets have to be exempt from taxation to prevent insolvency because of the tax burden carried – as mentioned above – by the beneficiary; for example, the

new shareholder who received the shares of an enterprise but no cash assets from which he or she might pay inheritance tax.

Because of the high importance of small and medium-sized enterprises in Germany, the legislative authorities decided to enact extensive tax exemptions for business assets of all kinds.

In general, the exemptions of the Inheritance and Gift Tax Act for business assets are applicable to all business assets and agricultural property. A basic business asset relief and an optional business asset relief are available. According to the basic relief, 85 per cent of the business assets will not be part of the tax base, and the remaining 15 per cent will be taxed immediately. There is an additional tax allowance for a transfer of business assets amounting to a maximum of €150,000. If the taxpayer chooses the optional relief, 100 per cent of the business assets will not be part of the tax base.

Business property may only benefit from the basic relief if it does not contain more than 50 per cent of passive non-operating assets. Passive non-operating assets are, generally speaking, leased real estate, minority shareholdings of 25 per cent or less, securities, cultural property and liquid funds if they exceed, after deduction of debt, 20 per cent of the business's total value. The optional relief is only available if the business assets consist of no more than 10 per cent of passive non-operating assets. Where the 50 per cent and 10 per cent requirements respectively are satisfied, passive non-operating assets may only benefit from the business assets relief if they have been part of the transferred business two years prior to the transfer.

Besides business assets, real estate as well as agricultural and forestry assets may benefit from tax exemptions. These exemptions lead to a number of tax-effective configurations, which – according to the Federal Fiscal Court of Germany (BFH) – can be used to achieve a preferential tax treatment for any kind of assets if the transferor chooses an appropriate configuration.[4] The BFH has consistently expressed its doubts concerning the constitutionality of the current Inheritance and Gift Tax Act. As the transfer of assets can be exempt from tax by structuring the assets in advance, equality of taxation is not ensured, according to the court. Even if the possibility to exempt liquid funds has been limited meanwhile, the BFH's concerns are still valid for a number of cases. As a consequence, the BFH has once again requested the BVerfG to give a ruling on the constitutionality of the current Inheritance and Gift Tax Act.

In its decision of 17 December 2014, the BVerfG held, that the currently applicable beneficial rules regarding the gratuitous transfer of business assets are inconsistent with the principle of equality in taxation.[5] According to the judgment, the privileges for business assets are disproportionate, in so far as they go beyond small and medium-sized enterprises without an economic needs test. Enterprises with up to 20 employees are disproportionately privileged by the aggregate wages and salaries regulation. The preferential treatment of up to 50 per cent administrative assets applies without any viable justification and the law allows for tax planning, which the Inheritance and Gift Tax Act does not aim to achieve and which cannot be justified under the principle of

4 BFH, decision of 5 October 2011 – II R 9/11.

5 BVerfG, decision of 17 December 2014 – 1 BvL 21/12.

equality. The BVerfG declared the continued application of the beneficial regulations and ordered the legislator to legislate until 30 June 2016.

In its cabinet decision dated from 8 July 2015, the German government proposed changes to the law in accordance with the findings of the BVerfG. According to the proposal, the passive non-operating assets test would be abolished in favour of a new regime, which classifies business assets tax-exempt only if they serve the 'main purpose of the enterprise'. Furthermore, generally acquisitions exceeding €26 million would be subject to an economic needs test on whether an exemption is applicable. This amount shall be doubled to €52 million if certain company-law requirements (e.g., restrictions concerning the distribution of profits) are met over a period of 10 years before and 30 years after the acquisition.

Even if business assets remain tax-privileged in some way to advance enterprises whose owners cannot afford an inheritance or gift tax of up to 50 per cent of the enterprise's value, the permitted asset structures will be restricted. Assets unrelated to business activities probably will no longer be able to participate in the exemptions for business assets. However, according to the Cabinet decision, unprivileged assets shall be treated as privileged up to an amount of 10 per cent of the privileged assets' net worth. For both individuals and family-owned enterprises, structuring of asset succession might be more difficult in the future. Individuals and owners of enterprises or shares in enterprises therefore already arrange their succession issues.

The affected persons are advised to plan the succession of their assets. With regard to inheritance and gift tax, conditions will probably worsen in the foreseeable future.

iii Tax treatment of trusts

Trusts are generally not recognised in Germany (see Section IV.iii, *infra*). Trusts can, however, trigger inheritance and gift tax in several ways; the establishment of a trust by residents (see Section II.i, *supra*) or of a trust comprising assets located in Germany is considered to be a transfer of assets that is taxable according to the Inheritance and Gift Tax Act. Distributions to beneficiaries during the trust period or on the trust's dissolution may trigger income tax and gift tax as well, if the beneficiary is a German resident or if German situs assets are distributed. The relationship between gift tax on the one hand and income tax on the other with regard to trust distributions has not yet been clarified by the courts.

In addition, corporate tax can be applied if income is received by a foreign trust from German sources. The worldwide income of a foreign trust may be subject to corporate tax if the trust's management is in Germany and if certain other conditions are met; for example, if the effective management of a trust is vested with a trustee resident in Germany.

Undistributed income received by a foreign trust can be attributed to the settlor or the beneficiaries if they are German residents. In this case, it can be subject to the settlor's or the beneficiary's personal income tax.

iv CFC rules in Germany – Section 7-14 of the Foreign Tax Act

Taxation in Germany generally cannot be avoided by establishing a foreign entity in a low-tax country. The German rules for the taxation of controlled foreign companies

(CFCs) meanwhile have an extensive scope of application. The CFC rules are settled in Section 7-14 of the Foreign Tax Act (AStG).

These CFC rules extend unlimited tax liability of residents to certain undistributed income of foreign corporations. The income may be attributed to domestic shareholders. The additional taxation under the CFC rules generally requires a substantial shareholding of German residents of more than 50 per cent of the corporation's shares (in certain cases, 1 per cent may suffice). The foreign corporation has to be an intermediate company, which receives passive or tainted income instead of income from its own business activities. Passive income is defined negatively by a list of active income in Section 8 of the AStG. Cumulatively, this passive income has to be subject to low tax rates of less than 25 per cent. Income that meets both criteria is added to a resident individual's income to the extent to which the individual holds shares in the corporation. The taxable person can choose whether the taxes paid on income received from an intermediate company in a foreign country will be deducted from the amount subject to the additional taxation in Germany or whether the foreign taxes shall be credited against the additional taxes levied in Germany. In most cases, the second alternative is advantageous for the taxable person.

A foreign corporation is not, however, supposed to be an intermediate company if, *inter alia*, its effective place of management or statutory seat is located in a Member State of the EU or the European Economic Area and if the corporation carries out substantial economic activities.

III SUCCESSION

i Wills

According to Section 2064 et seq. and 2229 et seq. of the German Civil Code there are two valid forms of wills: the holographic and the public will. The holographic will has to be handwritten, dated and signed by the testator. The public will has to be signed before, and certified by, a notary public. Neither form of will requires a witness.

A testator can also enter into a contract of succession with another person or a joint will with his or her spouse or civil partner. A contract of succession must be signed before, and certified by, a notary public; a handwritten contract does not meet the formal requirements.

By making a will, an individual can choose his or her heirs and provide what share each heir receives. Additionally, a legacy can be made; that is, a person can be empowered to make a claim against the heirs, without being an heir him or herself. This claim can be for an amount of money, a share of the deceased's estate, an item or anything else.

Wills made in a foreign jurisdiction can be valid in Germany. Germany recognises the HCCH Convention on the Conflicts of Laws Relating to the Form of Testamentary Dispositions 1961. A will is valid if it complies with the law of the state where the testator made the will, the state of the testator's nationality or residence, or – in the case of real estate – the location of the assets. Foreign grants and probates are not recognised. An heir must ask the competent probate court to issue a German certificate of inheritance.

ii Intestacy and forced heirship regime

If an individual dies intestate, intestacy rules apply. Under the intestacy rules, the deceased's estate is distributed among his or her relatives and spouse or civil partner in accordance with a strict order of succession. Children and their descendants constitute the first category, followed by parents and their descendants, grandparents and their descendants, and great-grandparents and their descendants. Relatives within a particular category inherit in equal shares (succession *per stirpes*). Where German law applies, the surviving spouse or civil partner also has a right of inheritance, determined by the matrimonial regime. Within a community of surplus, the surviving spouse or civil partner gets at least 50 per cent of the estate. If the deceased and his or her spouse or civil partner chose separation of property or community of property as their matrimonial regime, the surviving spouse or civil partner receives at least 25 per cent of the inheritance.

There is a forced heirship regime under which the descendants, the spouse or civil partner and the parents of the deceased are entitled to make a claim for a compulsory share of the deceased's estate if they are excluded from the testator's will or if the share granted to them is less than their compulsory share. A relative's compulsory share generally amounts to 50 per cent of the value of that relative's share on intestacy. It is a monetary claim and not a claim for a share of the estate. The compulsory share comprises all assets governed by German succession law (regardless of the beneficiary's residence). Therefore, the forced heirship regime can be avoided by buying assets that are situated abroad and that German succession law does not govern – for example, foreign real estate. Besides, a forced heir can renounce his or her right to his or her compulsory share during the testator's lifetime by signing a contract with the testator before a notary public. If the testator has died, a forced heir can also refrain from claiming his or her compulsory share.

iii Conflict of laws rules

Under the previous German conflict of laws rules, the applicable succession law was that of the deceased's nationality. If the deceased was a foreign national, German succession law applied only if the law of the deceased's nationality provided for a reference back to Germany (*renvoi*). This could be the case if the deceased was domiciled in Germany, if the deceased's habitual abode was in Germany or if the deceased held property or assets in Germany at the date of his or her death.

For successions as of 17 August 2015, new conflict of laws rules will apply because of the European Union's Succession Regulation. They will be valid in all EU Member States except Denmark, Ireland and the United Kingdom. According to the Regulation, the deceased's habitual abode at the time of his or her death instead of his or her nationality is relevant for the question of which succession law is applicable. If it is obvious that the deceased had a closer relationship to another state, that state's law will apply under certain circumstances. There is, however, the opportunity to opt for the succession law of an individual's nationality by a will, a joint will or by an agreement as to succession.

In addition, provisions on legal jurisdiction, recognition and enforcement of decisions and authentic instruments and on the European Certificate of Succession will

be part of the Regulation. As a general rule, the jurisdiction will be determined by the habitual residence at the time the individual dies.

IV WEALTH STRUCTURING AND REGULATION

i Commonly used structures: corporations and partnerships

Two structures are commonly used in Germany to hold assets: corporations and partnerships.

A corporation is subject to German corporate tax on its worldwide income if its effective place of management or statutory seat is located in Germany. In addition to corporate tax, a trade tax is also levied. Corporate tax, including a solidarity surcharge (see Section II.i, *supra*), and trade tax together combine to a tax rate of about 29 per cent. A participation exemption may apply, however, for dividends and capital gains. Profits distributed to shareholders of the corporation are subject to income tax at a flat rate of 25 per cent plus the solidarity surcharge.

A foreign corporation with income from German sources might be subject to German corporate tax. If a foreign corporation has a branch in Germany that constitutes a permanent establishment, the corporation will be subject to German corporate tax and trade tax with all income effectively connected to this permanent establishment.

Partnerships are fiscally transparent in Germany for income tax purposes. The partners are subject to income tax at their individual tax rates plus the solidarity surcharge. If the partnership is engaged in trade or business, the partnership itself is subject to trade tax. Trade tax levied from the partnership is (to a large extent) credited against the income tax of the partners if they are individuals.

ii Foundations

Foundations in Germany can be established either as charitable foundations or as family foundations. Charitable foundations are tax-privileged. Recognition as a charitable foundation requires that the foundation's activities be dedicated to the altruistic advancement of the general public in material, spiritual or moral respects. These purposes must be pursued altruistically, exclusively and directly. A charitable foundation may, however, use one-third of its income for the maintenance of the founder and his or her family. The formation of a charitable foundation neither triggers any inheritance or gift tax, nor transfer tax if real property is transferred gratuitously to the foundation. A charitable foundation is released from almost every current form of taxation, especially corporate tax and trade tax.

In contrast, a family foundation is not tax-privileged. It is conducted for the personal benefit and the advancement of one or more families. The formation of a family foundation and later donations to the foundation generally trigger inheritance and gift tax. The current taxation of a family foundation generally complies with the taxation of other legal persons. A family foundation can, however, receive income not only from trade or business but any type of income. In addition, only family foundations are liable for a substitute inheritance tax. This special tax accrues every 30 years. Moreover, distributions to beneficiaries are subject to income tax. The liquidation of a family foundation leads to an acquisition of assets on the level of the beneficiaries. This acquisition is treated

as a lifetime gift. Therefore, it is liable to gift tax. Income tax may be triggered as well. The classification of the tax bracket depends on the degree of relationship between the founder and the beneficiary.

In contrast to German family foundations, foreign family foundations are not liable for the substitute inheritance tax. However, the undistributed income of a foreign family foundation may be added to the personal income of the founder or the beneficiaries if they are tax-resident in Germany. This does not apply to family foundations that are resident in a Member State of the EU or the European Economic Area if it is assured that the foundation's property is separated legally and actually from the beneficiaries' property, and that a treaty regarding mutual administrative assistance exists between Germany and the state in which the foundation has its residence. These conditions have to be satisfied cumulatively.

iii Trusts

Neither domestic nor foreign trusts are recognised in Germany. Germany does not have its own trust law. Germany did not ratify the HCCH Convention on the Law applicable to Trusts and on their Recognition 1985. Therefore, German property law does not recognise the transfer of assets located in Germany to a trust. In these circumstances, the terms of a trust are interpreted in accordance with German law for civil law and tax purposes.

Where assets governed by foreign property law have been transferred to an irrevocable trust effectively formed under foreign trust law, the trust can shelter these assets from the settlor's or beneficiary's creditors. German courts generally do not recognise claims against trust assets on the dissolution of a marriage or partnership after 10 years from the date of the transfer.

Foreign trusts are disadvantaged in terms of tax issues when they are established or when distributions to beneficiaries are made (see Section II.iii, *supra*).

V CONCLUSIONS AND OUTLOOK

The tax and legal conditions for succession in both private assets and family-owned enterprises are advantageous in Germany at the moment. Many individuals make use of the exemptions the current Inheritance and Gift Tax Act offers for the transfer of business assets and other types of assets. These exemptions may be abolished by the legal authorities in the foreseeable future. Therefore, conditions will probably worsen, and enterprises as well as wealthy individuals are well advised to structure succession as long as the current conditions are in force.

Succession law, on the other hand, will (at least within the EU) become more flexible as of 2015, when the European Union's Succession Regulation becomes effective.

Usually, corporations as well as partnerships are used to structure assets and transfer them to the next generation. Family foundations and charitable foundations may be a proper structure from time to time. Trusts, however, are not recognised in Germany. In comparison with corporations and foundations, they are disadvantaged if beneficiaries of a foreign trust have their permanent home or their habitual abode in Germany.

Appendix 1

ABOUT THE AUTHORS

ANDREAS RICHTER

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Dr Andreas Richter, LLM is a partner at P+P Pöllath + Partners in Berlin. Some of Germany's leading family offices, family businesses and foundations, as well as their peers abroad, form the client base for Andreas' work as a legal and tax adviser. Andreas is widely acknowledged as one of Germany's pre-eminent private client lawyers.

The quality of Andreas' cross-border work was honoured by his election as Academician of the International Academy of Estate and Trust Law. He has outstanding experience in business and wealth succession, estate planning, legal and tax structuring of private wealth and family offices, corporate governance for family-owned businesses, expatriation taxation, and charities, as well as in trust and foundation law. Clients in common law jurisdictions regularly instruct Andreas because of his background in English law (BA Hons, Trinity College, Cambridge) and US law (LLM, Yale Law School).

Andreas is the managing director of the Berlin Tax Policy Forum, a leading country-wide forum for debate on tax policy. He chairs the executive board of the postgraduate programme 'Business Succession, Inheritance Law & Asset Management' at the University of Münster. He serves as a member on the boards of family offices, foundations and family businesses and acts as executor. Andreas is the author and editor of numerous publications, commentaries and compendiums, in particular on family offices, foundation law, business succession and all tax-related matters.

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Dr Anna Katharina Gollan LLM is admitted as attorney-at-law and specialist tax lawyer. As a counsel at P+P Pöllath + Partners she focuses on legal and tax advice with regard to inheritance law, succession planning, foundation law and non-profit law. Dr Gollan is an adjunct lecturer for non-profit and foundation law as part of the postgraduate programme 'Business Succession, Inheritance Law & Asset Management' at the University of

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