The Private Wealth & Private Client Review

Second Edition

Editor
John Riches

Law Business Research

THE PRIVATE WEALTH & PRIVATE CLIENT REVIEW

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EDITOR'S PREFACE

The overarching trends identified in my introduction to the first edition of *The Private Wealth and Private Client Law Review* in 2012 have remained dominant themes in the world of private wealth and tax planning in 2013. Perhaps the most telling comment that was made in relation to last year's chapter was from our German contributor, Andreas Richter, who felt that the rest of the world was finding itself in a situation that had been commonplace with regard to private wealth planning in Germany for the past two decades! The main areas that I will address in my preface for 2013 are the unstoppable rise of tax and information exchange agreements, the morality of tax planning and the deepening interest in areas of family governance.

Tax and information exchange

We have recently heard that the United States has deferred the introduction of its Foreign Account Tax Compliance Act (FATCA) for a further six months. What is fascinating in charting the FATCA project's progress is that, having adopted regulations that are applicable to jurisdictions with whom no bilateral intergovernmental agreement has been signed, the United States has effectively embarked upon a campaign of entering into either Type I or Type II intergovernmental agreements with all major trading partners and mainstream offshore jurisdictions. What is unprecedented in these bilateral agreements is the acceptance, for the first time, by the United States that it will agree to automatic exchanges of information with the other contracting states in relation to information held in the United States about taxpayers of the other contracting states. While this appears to be a major concession on the part of the United States, it is hampered in practice by the fact that the United States has not had the same history of collecting beneficial ownership information on non-US persons holding assets in the United States as has prevailed in Europe and the major offshore financial centres. It is quite clear that other jurisdictions have, to a certain extent, been 'falling over themselves' in their rush to introduce their own FATCA arrangements. The absence of a common standard and the potential introduction of a plethora of bilateral agreements between

major jurisdictions can only increase the prospective complexity from a compliance perspective. It is apparent from these developments that, going forward, the importance attached to meticulous compliance with home country tax obligations will be enhanced. While the primary target of tax information exchange is to identify taxpayers with undeclared funds in other jurisdictions, it would not be surprising if the main targets in future of revenue authorities were to change to taxpayers with declared assets, where the absence of long-term record keeping means that the ability to accurately compute historically covered gains that were chargeable is significantly affected. I was recently quite alarmed to find that, going back to the late 1990s, the ability to obtain original bank statements for a particular trust structure posed a significant challenge following a change of trustee. It is in such circumstances that an inability to verify the precise source of income and gains could generate significant forward compliance problems. This underlines the importance of meticulous record keeping for past transactions and appropriate data-storage arrangements for long-term structures.

Morality of tax planning

Politicians from many jurisdictions continue to play the 'morality' card in their efforts to attract voter support. The primary focus of political and press comment in the morality field to date has been directed at big-name multinational corporates who appear not to be paying what might be regarded as acceptable levels of tax in different jurisdictions. It may only be a matter of time, however, before the focus switches to private client structures. Significant pressure was brought to bear at the recent G8 summit in Northern Ireland on the question of whether there should be public registers of beneficial ownership. It now appears that the pressure to override privacy in these circumstances has somewhat abated, but we cannot be certain that this reprieve will be anything other than shortlived. Many more clients are now concerned to ask whether their planning arrangements are 'mainstream' or would be regarded as 'aggressive' if they were subject to intense scrutiny. The difficulty in addressing these issues for private families is that public opinion does not overly concern itself with subtle nuances when it looks at family wealth structures. The automatic assumption that any cross-border planning is inherently suspicious or aggressive is hard to shake even if one is dealing with financial journalists from quite respectable newspapers.

In these circumstances I think it behoves advisers not to temper the exaggerated concerns that clients may feel but to offer a long-term perspective where planning that is not 'mainstream' is carefully weighed for its long-term reputational consequences before being entered into. Clearly, clients will have different levels of sensitivity in this area, but the prevailing public mood is undoubtedly affecting clients' appetites for engaging even in tax planning that is solidly mainstream.

Family governance

In parallel with the greater focus on compliance that has been driven by the policy changes on tax information exchange noted above, many families continue to focus more explicitly on internal family governance arrangements, particularly where their asset base encompasses active trading businesses. In this context, the growing popularity of multi-generational family charters as core documents in which families engage together is, in many cases, rapidly replacing a founder's monolithic vision for his or her personal

wealth, which is simply handed to the next generation as, in effect, 'tablets of stone'. There are significant risks in engaging with the next generation on wealth issues if the process is not carefully managed. The ability of lawyers and tax advisers to cooperate in a harmonious way with family business and governance specialists is becoming an important factor in enabling advisers to deliver integrated tax succession and governance solutions to family clients of all sizes.

I recommend the 2013 edition to you and am delighted to welcome new contributors and to expand coverage to include Austria, China and Italy.

John Riches
RMW Law LLP
London
September 2013

Chapter 15

GERMANY

Andreas Richter and Jens Escher[1]

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 continually 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.

1 Andreas Richter is a partner and Jens Escher is a counsel at P+P Pöllath + Partners.

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 per cent 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 (for example, 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 case 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 per cent 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 per cent 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 per cent to 43 per cent. Between unrelated persons, the applicable tax rate is 30 per cent or 50 per cent (for more than €13 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 per cent to 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 per cent 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, but certain political parties have demanded a quick relaunch of the wealth tax with tax rates of 1 per cent or 1.5 per cent and personal allowances of €1 million to €2 million for individuals.

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, especially of business assets. The core problem was, and still is, if and how business assets have to be exempt from taxation in order 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 and cultural property. 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] Consistently, the BFH has 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. As a consequence, the BFH has requested that the BVerfG once again give a ruling on the constitutionality of the current Inheritance and Gift Tax Act. It is expected that the Act – similarly to its predecessor – will be held to be unconstitutional by the BVerfG within the foreseeable future and that the legislator will be requested to amend the law once more.

Although the legislator has only recently, in anticipation of the BVerfG's decision, closed some loopholes in the Act that were frequently used for tax-efficient structuring of private assets, another reform of the exemptions from inheritance and gift tax within the next few years seems to be inevitable. Even if business assets remain tax-privileged in some way in order 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

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

to participate from the exemptions for business assets. 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. Although it is impossible to predict when the Inheritance and Gift Tax Act might be changed, 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.ii, *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 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 hand, 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 (see Section IV.iii, *infra*).

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 (CFC) 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 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 which 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 German conflict of laws rules, the applicable succession law is that of the deceased's nationality. If the deceased was a foreign national, German succession law applies only if the law of the deceased's nationality provides for a reference back to Germany (*renvoi*). This will 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.

As of 2015, new conflict of laws rules will become effective due to the European Commission's Succession Regulation. On 8 June 2012 the Council of Ministers of Justice of the EU decided on the proposal for regulation that will be valid in all EU Member States except Denmark, Ireland and the United Kingdom. According to the Regulation, the deceased's last habitual abode instead of his or her nationality is relevant for the question of which succession law is applicable. There is, however, the opportunity to opt for the succession law of an individual's nationality by will or by a contract of succession. Nevertheless, if it is obvious that the deceased held a closer relationship to another state, that state's law will be applicable under certain circumstances.

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. Legal jurisdiction will be determined by the habitual abode at the time the individual dies, but under certain requirements, the court can be selected by will, contract of succession or legacy.

IV WEALTH STRUCTURING AND REGULATION

i Commonly used structures: corporations and partnerships

There are two different structures that 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 might be subject to German corporate tax with income from German sources. Where 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 which 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. With regard to the latest treaties, family foundations based in Liechtenstein may also fulfil these requirements.

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 ten years from the date of the transfer.

For tax issues, foreign trusts are disadvantageous 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; a wealth tax might also be reintroduced. 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 become more flexible at least within the EU as of 2015, when the European Commission's Succession Regulation becomes effective. Until then the applicable succession law is that of the deceased's nationality according to German conflict-of-laws rules. Different rules apply for real property and other assets effectively connected with Germany.

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

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Andreas Richter LLM is a partner at P+P Pöllath + Partners. He is an academician of the International Academy of Estate and Trust Law. He has outstanding experience in business succession and estate planning, legal and tax structuring of private wealth and family offices, corporate governance for family-owned businesses, expatriation taxation, charities, as well as trust and foundation law. Dr Richter is the managing director of the Berlin Tax Forum and chairman of the executive board of the postgraduate 'Business Succession, Inheritance Law and Asset Management' programme at the Westphalian Wilhelm University of Muenster. He serves as a member on boards of family offices, foundations and family businesses and acts as executor. He 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. He is continually listed as one of Germany's leading advisers for private clients and trusts in independent domestic and international rankings.

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