

German Gift Tax on Trust Distributions

by Maximilian Haag and Andreas Richter

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PRACTITIONERS' CORNER

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Maximilian Haag and Andreas Richter are with P&P Poellath & Partners in Munich and Berlin, respectively.

In a September 27, 2012, decision, the German Federal Tax Court (Bundesfinanzhof) left no doubt that all distributions from foreign trusts to beneficiaries with their residence or habitual abode in Germany are subject to the German gift tax. According to the court, this rule applies to both discretionary and fixed-interest trusts and regardless of whether a trust distributes income or part of its assets. Unfortunately, the German Federal Tax Court did not comment on the issue of whether distributions of trust income are subject to both gift tax and German income tax. Therefore, because of the definitive imposition of gift tax and the possibility of additional income taxation, the advantages and risks of establishing a trust for estate planning purposes should be carefully considered if one of the beneficiaries is resident in Germany.

The tax treatment of foreign trusts under German law has been unclear for many years. German civil law does not recognize the concept of a common law trust. To date, Germany also has not acceded to the convention of July 1, 1985, on the law applicable to trusts and on their recognition. Therefore, German lawmakers and the German revenue service originally had no reason to implement specific rules on the taxation of trusts. Only in 1999 was the German Inheritance and Gift Tax Act (Erbschaft- und Schenkungsteuer-gesetz, or GGTA) amended to explicitly include in gift taxation some events relating to foreign trusts.¹

¹Section 7, para. 1, no. 8, sentence 2, no. 9, sentence 2 of the GGTA.

Formation of Trust

The formation of a foreign trust is subject to German gift tax if the settlor at formation of the trust or later loses all rights or powers enabling him legally or effectively to dispose of the trust assets, and if the settlor has his residence or habitual abode in Germany or he is a German national who had his residence or habitual abode in Germany at some point during the last five years before the trust's formation.²

Nomination of Beneficiaries

The mere nomination of a beneficiary with residence in Germany will generally not trigger the German gift tax. A taxable gift to a German beneficiary may be assumed only if the beneficiary by virtue of the trust deed acquires rights or powers that enable him legally or effectively to dispose of the trust assets.³ This is a question of all facts and circumstances.

Death of the Settlor

The death of the settlor will also not trigger inheritance tax at the level of a German beneficiary if the beneficiary at the death of the settlor does not receive rights or powers that enable him legally or effectively to dispose of the trust assets.⁴

²Section 7, para. 1, no. 8, sentence 2; and section 2, para. 1, no. 1 letter a), b) of the GGTA.

³Section 7, para. 1, sentence 1, no. 1 of the GGTA; compare German Federal Tax Court of June 28, 2007 — II R 21/05.

⁴Section 3, para. 1, no. 1 of the GGTA; German Federal Tax Court of June 28, 2007 — II R 21/05.

Dissolution of Trust

The dissolution of a foreign trust is subject to German gift tax if the trust assets are paid out to beneficiaries who have their residence or habitual abode in Germany or had their residence or habitual abode in Germany at some point during the last five years before dissolution of the trust.⁵

Trust Distributions

Even though the number of controversial tax cases involving foreign trusts increased after the enactment of the 1999 gift tax laws, court guidance on the gift tax rules applicable to trust distributions remained incomplete. Whereas the revenue service believed that all trust distributions of both trust capital (that is, the principal amount) and trust income should be subject to gift taxation and that no distinction should be made between fixed-interest and discretionary trusts, several commentators contested this construction of the law. Some argued that trust income should not be included in gift taxation since it — under some circumstances — is already subject to income taxation. Others explained that gift tax should apply only to discretionary trusts and not to fixed-interest trusts since fixed-interest distributions of private foundations under German tax law are free of gift tax.

With its September 27, 2012, decision, the German Federal Tax Court (II R 45/10) now has disapproved of the several arguments brought forward by commentators and fallen into line with the revenue service and the previous decision of the court of lower instance.⁶ Thus, any distribution of trust income or trust assets to beneficiaries with residence in Germany will be subject to German gift tax under GGTA section 7, paragraph 1, sentence 1, no. 9, sentence 2 (provided the receiving beneficiary is not the settlor himself). Regarding the consequences of this strict rule, Tax Class I, the lowest tax class, applies only if the beneficiary is a descendant of the settlor.⁷ In Tax Class I, the top gift tax bracket of 30 percent applies to aggregated distributions in excess of €26 million within 10 years, and a tax rate of 19 percent or higher applies to aggregated distributions in excess of €600,000 within 10 years.⁸ These rules may apply to both irrevocable and revocable trusts.

Additional Tax on Distributed Income?

Strangely enough, in its decision of September 27, 2012, the German Federal Tax Court did not comment on whether and under which conditions trust distributions subject to gift tax may also be subject to German

income taxation. Under the provisions of the German Income Tax Act (Einkommensteuergesetz) any (fixed-interest or discretionary) distribution of trust income to a beneficiary resident in Germany will likely be taxed at a flat rate of 26.375 percent.⁹ Also, even if a foreign trust does not distribute any income, income accumulated by the trust may be subject to annual income taxation in Germany under specific CFC-like rules for some foreign foundations and trusts (section 15 of the German Foreign Transaction Tax Act (Aussensteuergesetz)).

If a foreign trust holds interests in separate foreign corporate investment vehicles, the German revenue service will apply the regular German CFC rules to them. Resident beneficiaries are then also taxed on the income of such trust vehicles. It is unclear whether German law extends income taxation to distributions of trust capital (that is, principal amount) even though several commentators dismiss this idea.¹⁰ In sum, trust distributions to beneficiaries resident in Germany can have considerable income tax consequences.

The German revenue service does not explicitly preclude income taxation on trust distributions that have already been subject to German gift tax.¹¹ Instead, the revenue service tends to assume double taxation in similar situations (for example, gift tax on constructive or deemed dividends). Even some commentators hold this point of view.¹² Thus, there is a high risk that the German service subjects trust distributions to beneficiaries resident in Germany to both gift tax and income tax. This could result in double taxation since statutory relief for income previously subjected to inheritance tax (section 35b of the German ITA) is not applicable to donations *inter vivos*.

Summary

In summary, German gift tax will apply to all distributions of a foreign trust to a beneficiary resident in Germany regardless of whether such distributions are also subject to German income tax. Even though it is not convincing to qualify distributions as gifts to the beneficiary for gift tax purposes and, at the same time, as earnings of the beneficiary for income tax purposes, a serious risk of double taxation remains if a beneficiary receiving distributions of a foreign trust has his residence in Germany or had a German residence at some point during the last five years before the distribution. Similar tax risks exist for the events of formation and dissolution of a foreign trust with resident beneficiaries. ♦

⁹Section 20, para. 1, no. 9, sentence 2; and section 32d, para. 1 of the German ITA.

¹⁰Desens and Hummel, *DSiZ* 2011, 719; Pohl and Hoehfeld, *Unternehmens- und Vermoegensnachfolge*, 2d ed. 2002, footnote 1636.

¹¹German Federal Ministry of Finance ruling of June 27, 2006 — IV B 7-S 2252 — 4/06.

¹²Juelicher, *ISiR* 2002, 203; Habammer, *DSiR* 2002, 431; Schuetz, *DB* 2008, 607, contested by Milatz and Herbst, *BB* 2011, 1503; Fueger and von Oertzen, *ISiR* 1999, 15.

⁵Section 7, para. 1, no. 9, sentence 2; and section 2, para. 1, no. 1, letter a), b) of the GGTA.

⁶Tax Court (Finanzgericht) Baden-Wuerttemberg of July 15, 2010 — 7 K 37/07.

⁷Section 15, para. 2, sentence 2 of the GGTA.

⁸Section 19, para. 1 of the GGTA.