What's the score?

Dr Andreas Richter and Dr Maximilian Haag explain how the will trust can be used for Anglo-German estate planning without incurring a hefty tax bill

> A trust can currently only be acknowledged by German courts if the law applicable to the estate is not German law but a system of law that recognises trusts

On 17 August 2015, *Regulation (EU) No.650/2012* (the Succession Regulation) will substantially change the conflict-of-laws rules applicable to successions by death in all EU member states, except the UK, the Republic of Ireland, and Denmark. Therefore, all assets with a *situs* in one of the other member states, including Germany, will become subject to uniform conflict-of-laws rules. Assets with a *situs* outside these member states will remain subject to the relevant conflict-of-laws rules of the jurisdiction in which they are located, e.g. the UK. At the same time, such assets might be treated differently under the rules of the Succession Regulation if the testator or their heirs have a nexus to one of the member states bound by the Succession Regulation. This could result in complex legal conflicts that must be tackled on a case-by-case basis.

This article concentrates on assets with a *situs* in one of the member states applying the Succession Regulation: Germany. The following example illustrates the issues of legal recognition and inheritance tax liability in Germany surrounding the common-law will trust when used as an instrument of Anglo-German cross-border estate planning.

The testator, Thomas, was born in Frankfurt of German parents. The family went to London when Thomas was three years old. Thomas is a citizen of the UK only. Thomas owns a flat in Berlin, which he has rented out, and has a German bank account. He is convinced that a will trust is the only viable instrument for regulating his succession. He wants to leave two-thirds to his wife, Anthea, absolutely; one-third to his daughter, Sophie, for life; and the remainder to his other daughter, Dorothy, and his son, Stuart. Sophie has been living in Hamburg for 20 years, whereas Dorothy and Stuart have spent all their lives in London. Thomas asks how his will trust should be drafted to minimise tax liability in Germany.

A transfer of Thomas' assets out of his will trust to Sophie constitutes a receipt of assets on death.[1] Such a transfer only triggers German inheritance tax liability, however, if somebody is personally liable for tax.[2] That is the case if the deceased at the time of death, or the recipient of the transfer at the time at which tax liability generally arises, has their residence (*wohnsitz*) or their habitual abode (*gewöhnlichen aufenthalt*) in Germany.[3]

In Thomas' case, Sophie resides in Germany; any transfer out of the will trust to Sophie, therefore, amounts to a receipt of assets, which triggers tax liability. Dorothy and Stuart's remainder shares are not subject to any German taxation, due to their missing link to Germany.

Depending on the classification of the receipt by Sophie, however, different results as to German tax liability emerge. This article will give recommendations for drafting a trust instrument with a connection to Germany, as in Thomas' case, in order to minimise German inheritance tax liability. Before examining inheritance tax liability, the treatment of will trusts under German civil law is an essential preliminary inquiry.

WILL TRUSTS IN GERMAN CIVIL LAW

Germany is not a signatory party to the *Hague Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition*. Thus, trusts are unknown to German civil law, whether settled by will or *inter vivos*. A trust can only be acknowledged by German courts if the law applicable to the estate (*lex successionis*) is not German law but a system of law that recognises trusts.

Under current German conflict-of-laws rules, the *lex successionis* is the law of the country of which the deceased was a national at the time of their death.[4] For Anglo-German estate planning, this means that exclusively English nationals can use a common-law will trust to plan the succession to their estate, provided that the testator has their domicile in England. If the English testator had their domicile of origin in Germany, a *renvoi* would be made and German law would be applied as a consequence.[5]

This could happen to Thomas if it was assumed that his domicile of origin was in Germany. If that was the case, German courts would first apply English and Welsh law, which would make a *renvoi* to German law. As a consequence, English and Welsh law would only apply to his immovable assets in the UK. His Berlin flat and his German bank account would be governed by German law. As a result, these assets could not form part of the subject matter of the trust.[6]

The conflict-of-laws rules in Germany will change, however, in the near future. Deaths on or after 17 August 2015 will be governed by the Succession Regulation.

The *lex successionis* will then be the law of the country in which the deceased had their habitual residence at the time of death.[7] This means that will trusts of non-English testators will be construed in accordance with English and Welsh law if the settlor had their last habitual residence and their domicile in England. Conversely, the succession to the estate of an English testator who lives in Germany and has no habitual residence in England would be governed by German law and a will trust would, therefore, be void.

The legal response to the first scenario differs if the non-English testator with their last habitual residence in England has their domicile in Germany. Then, English law makes a *renvoi* to German law and the trust will be void.[8]

The English testator can avoid this consequence by making a choice of law. A testator can choose to have the law of the state of which they are a national applied to their succession if the choice is made expressly in a disposition of property upon death or is demonstrated by the terms thereof.[9] If a choice of law is made, a *renvoi* is barred.[10] Thus, the succession to the estate of an English settlor who has their last

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1 Section 1(1)(1) *German Inheritance and Gift Tax Act* (GGTA)
2 Section 2 GGTA
3 Section 2(1)(1)(a) GGTA
4 Article 25(1) *Introductory Act to the Civil Code* (IACC)
5 Article 4(1), sentence 1 IACC
6 In German law, the number of real rights is limited (*numerus clausus*) and their content is fixed by law (*typenzwang*). In particular, splitting property into a legal and an equitable title is impossible
7 Article 21(1) Succession Regulation. Although the Succession Regulation lacks a definition of 'last habitual residence', guidance as to its scope is given in recital 23; see: EuGH 2.4.2009, Rs C-523/07 (A) Slg 2009, I-2805; EuGH 22.12.2010, Rs C-497/10 PPU (*Mercredi*) Slg 2010, I-14309, IPRax 2012, 340
8 Article 34(1) Succession Regulation
9 Article 22(1) and (2) in conjunction with article 3(1)(d) Succession Regulation
10 Article 34(2) Succession Regulation

habitual residence and even their domicile in Germany, but chooses English and Welsh law as their *lex successionis*, will be governed by English and Welsh law as far as Germany is concerned. Since the UK is not subject to the Succession Regulation and for sake of clarity, it may, nevertheless, be prudent to add to the choice-of-law clause that English conflict-of-laws rules are explicitly excluded from the choice of law.

Thomas' situation is a good example of the uncertainties surrounding cross-border estates: it is uncertain whether Germany is the place of his domicile of origin. It is, therefore, advisable for Thomas to make a choice in favour of English and Welsh law as the *lex successionis* to his estate. This will ensure the implementation of his will trust in accordance with English and Welsh trust principles.

In conclusion, from an Anglo-German perspective, the Succession Regulation will affect testators who wish to plan the succession to their estate by means of a will trust in two scenarios:

- A non-English testator will be able to make use of a common-law will trust, which will be recognised in the German jurisdiction if they have both their last habitual residence and their domicile in England.
- An English testator with some habitual link to Germany (more than negligible) should make an express choice of English and Welsh law in their will if they wish their will trust to be recognised by German courts and treated according to the English and Welsh law of trusts.

GERMAN INHERITANCE TAX LIABILITY

Having explained how English and Welsh law can become applicable as the *lex successionis*, the taxation of the receipt of assets out of a will trust under German law will now be considered.

Since the *German Inheritance and Gift Tax Act* was amended in 1999,[11] there has been a strong tendency to classify a will trust as a so-called 'conglomeration of assets' (*vermögensmasse*).[12] This can lead to multiple taxation:[13] once when the will trust takes effect, i.e. on the death of the settlor;[14] then again while the trust is up and running every time the trust makes profits,[15] and trust assets are distributed (*ausschüttungen*);[16] and again when the trust is dissolved.[17] Furthermore, due to a lack of court guidance on this issue, it cannot be ruled out that the *ausschüttungen* might actually attract double taxation: not only through inheritance tax but additionally through income tax.[18] Despite objections by constitutional lawyers, there is no statutory relief applicable to the potential double taxation and the German revenue service did not rule it out explicitly.[19] This makes the will trust unappealing for Anglo-German estate planning. This deterrence was the intention of the reforms in 1999.

There is, however, a way to avoid these ramifications: if drafted carefully, a will trust can be aligned with a legacy (*vermächtnis*)[20] in terms of German inheritance tax law. A *vermächtnis* is the transfer of a material benefit on death.[21] That means the beneficiary is not the heir but merely receives a right to the assets they are entitled to under the will trust against the heirs. In Thomas' case, Anthea is the heir and Sophie's entitlement is comparable to a legacy.

There are several issues to take into account when drafting the will trust so as to align it with a legacy in terms of German tax law. Two of them are highlighted below.

Subject matter of the trust

It is advisable to specify this as being the net assets after all obligations have been deducted. Since outstanding obligations must be performed by the trustees, the beneficiary can be regarded as the recipient of a legacy (*vermächtnisnehmer*).

This does not prevent there being multiple beneficiaries, each acquiring a share of the subject matter (*quotenvermächtnis*).[22] German inheritance tax liability will only arise for the share with a link to Germany, like Sophie's share in Thomas' case.

Maximum duration of life tenancy

The beneficiary should not have a life tenancy under the trust that lasts longer than 30 years, i.e. the latest point of time at which the beneficiary must be absolutely entitled (to their share) is the 30th anniversary of the death of the settlor. This ensures compliance with the regular permanent executorship provisions (*dauertestamentsvollstreckung*) of German law.[23] Inserting a remainder for that time is possible; it corresponds to the German *nachvermächtnis*.

That means Thomas should change the trust instrument accordingly; Sophie's life tenancy must be limited to 30 years after the death of Thomas, at which point she must take absolutely. Thus, the remainder for Dorothy and Stuart should only be effective for this period. During that time, distributions can be made to Sophie without any extra taxation.

Provided that the two above-mentioned points are observed, there is an argument to be made that German inheritance tax liability will only arise once: at the time of the death of the testator, analogous to a legacy.

SUMMARY

A testator with an Anglo-German background does not have to abstain from using a will trust as an instrument for planning the succession to their estate because of concerns about extensive tax liability in Germany, if certain points are observed. First, the testator has to arrange for the applicability of English and Welsh law, so as to ensure implementation of the will trust in accordance with the settlor's intention. Second, the provisions of the will trust have to be aligned with a legacy so as to avoid the disadvantageous German classification as a conglomeration of assets. If drafted carefully, the transfer of assets out of the will trust will give rise to inheritance tax liability no higher than transfer without a trust.

Attention also has to be given to the new regime under the Succession Regulation. On the one hand, it offers opportunities for non-English nationals who live in England. English testators who live in Germany, on the other hand, should take steps to ensure proper recognition and treatment of their will trusts by German courts.

11 Article 12 *Steuerentlastungsgesetz* 1999/2000/2002 from 24 March 1999 (BGBl I 1999, 402)
12 Section 2 *Corporate Income Tax Act*; BFH of 5 November 1992 (I R 39/92) BStBl 1993 II, page 388
13 Habammer, 'Der ausländische Trust im deutschen Ertrag- und Erbschaft-/Schenkungsteuerrecht', in DStR 11 (2002), pages 425–432
14 Section 3(2)(1) GGTA
15 Section 15 *Foreign Transactions Tax Act*
16 Section 7(1)(9) GGTA; German Federal Finance Court of 27 September 2012 (II R 45/10) approving the lower Tax Court Baden-Württemberg of 15 July 2010 (7 K 37/07); see Dr A Richter and Dr M Haag, 'German Gift Tax on Trust Distributions', in *Tax Notes International*, Vol 70, Nr 13 (24 June 2013), pages 1307–1308
17 Section 7(1)(9) GGTA
18 Section 20(1)(9) and s32(d)(1) German *Income Tax Act*
19 German Federal Ministry of Finance ruling of 27 June 2006 – IV B 7-S 2252 – 4/06
20 Section 2147 of the German *Civil Code* (GCC)
21 Section 1939 GCC
22 Edenhofer in Palandt, *Bürgerliches Gesetzbuch*, introduction to s2147ff, rec 1f
23 Section 2197(1); s2209; s2210 GCC; BayObLGZ 1980, 42; compare Edenhofer in Palandt, introduction to s2197, rec 8


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