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Private Wealth and Private Client

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Chapter 8

GERMANY

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I INTRODUCTION

Private wealth and private client law in Germany is 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 the consistent and proportionate application of German civil and tax law.

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

Further, families have become increasingly international, which creates major challenges with regard to international tax issues, for example, exit taxation in Germany.

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 or a habitual abode 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.

With regard to income tax, there is a progressive tax rate ranging from 14 to 45 per cent. An additional solidarity surcharge of 5.5 per cent of the tax liability was generally levied until the end of 2020. This surcharge was intended to finance German reunification in 1990. As of 1 January 2021, the solidarity surcharge was completely abolished for 90 per cent of income tax payers. Currently, only high earners, investors who have exhausted their savings allowance, as well as limited liability companies and other corporations, are still subject to the solidarity surcharge.

As previously 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

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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 successor or donee (hereinafter both referred to as transferee) is liable for the tax on the value of the assets 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 deceased or donor (hereinafter both referred to as transferor) and the transferee, and on the value of the assets 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. Children receive a personal allowance of €400,000 and an age-dependent maintenance allowance of up to €52,000; grandchildren receive a personal allowance of €200,000. 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 a transfer of more than €6 million).

Unlimited tax liability is triggered if either the transferor or the transferee is resident in Germany, regardless of whether the assets received are effectively connected to Germany. If neither the transferor nor the transferee is resident, inheritance and gift tax is only due on certain assets 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. Further, the extended unlimited inheritance tax liability may apply in certain situations. A German citizen is a deemed German resident for inheritance and gift tax purposes for five more years (when moving to the US, even 10 more years) after having left Germany. The German Federal Fiscal Court recently confirmed that this extended unlimited inheritance and gift tax liability is constitutional. If the new country of residence does not have a double taxation treaty in the field of inheritance and gift tax, it may lead to double taxation of inheritances and gifts in the mentioned period.

Besides income tax and inheritance and gift tax, only a few other taxes are relevant for private clients. A real estate 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 90 per cent) in a company holding real estate. Furthermore, real estate tax is levied annually and is calculated on the basis of rates determined by the local authorities, and property values, which were last assessed in 1964 or 1935. However, the German Federal Constitutional Court found that these obsolete valuation methods are inconsistent with the constitutional principle of equality of taxation. In June 2019, the federal government therefore sent a draft to the German Parliament that was supposed to change how the assessment of property values is conducted by local authorities from 1 January 2022 onwards. Due to the new tax law, more than 30 million properties had to be reassessed. Therefore, property owners had to submit tax returns in 2022. For this, each federal state has requested different information from taxpayers, which further complicates the matter. Again, there are reasonable arguments that also the new assessment methods are unconstitutional, and legal actions against the new provisions are expected.

Wealth tax has not been levied in Germany since 1997. Since then, there have already been numerous impulses in the political landscape for either reintroducing the tax or introducing a one-time wealth fee. This demand could even be found in some of the parties' election programmes for the 2021 federal election. Based on the current composition of the federal government, the introduction of a wealth tax is considered unlikely.

As a result of European directive DAC 6 requirements, a law was introduced at the end of 2019 obligating any person that markets, designs, organises or makes a cross-border tax arrangement available for implementation or manages the implementation for third parties (intermediaries) to disclose these to the respective tax authorities. In some cases, the reporting obligation may also be applicable to the relevant taxpayer of a cross-border tax arrangement.

ii Taxation of business assets under the Inheritance and Gift Tax Act

The inheritance tax law has been reformed several times, most recently in 2016. Exemptions of the Inheritance and Gift Tax Act for business assets are still widely available. The transferee may choose between a basic relief and an optional relief. According to the basic relief, 85 per cent of the business assets do not form part of the tax base and the remaining 15 per cent only are taxed. If the taxpayer chooses the optional relief, 100 per cent of the business assets are not considered part of the tax base. The relief is, however, conditional upon the continuing operation of the business for a certain amount of time (retention period) and the preservation of jobs. The retention period amounts to five years for the basic relief and seven years for the optional relief. Regarding the preservation of jobs, depending on the relief model chosen and the number of employees, after the retention period, the total payroll has to amount to at least 250 to 700 per cent of the payroll before the transfer.

Furthermore, business assets can only benefit from the relief insofar as they do not constitute passive non-operating assets. Passive non-operating assets are, generally speaking, leased real estate, minority shareholdings of 25 per cent or less, securities, certain movables like artwork, antique cars and yachts, and liquid funds if they exceed, after deduction of debt, 15 per cent of the business' total value.

The passive non-operating assets are fully taxable at the regular rate if their value exceeds 10 per cent of the total business assets (the contamination clause). In extreme cases, if the passive non-operating assets equal 90 per cent or more of the value of the whole business, the remaining potentially tax-privileged assets of up to 10 per cent are excluded from all relief, too, to avoid any misuse. New passive non-operating assets (i.e., those assets that were contributed to the business assets within a period of two years before the relevant transfer) are completely excluded from any form of relief.

In contrast to before 1 July 2016, relief can no longer be claimed independently from the value of the business assets transferred. If the value of the assets exceeds €26 million, the transferee may choose between two relief models: an ablation model or an economic needs test. According to the ablation model, the extent of relief is reduced by 1 per cent for each €750,000 in company value exceeding €26 million. The result is that there is no longer any relief for acquisitions of approximately €90 million. The economic needs test, on the other hand, focuses on the transferee as a person and examines his or her assets. Out of his or her entire non-exempt assets after the transfer, the transferee is required to spend up to 50 per cent for the taxes due on the transferred business assets. Only if the 50 per cent of assets are not sufficient will an exemption from inheritance tax be considered upon request. Finally, it is noteworthy that the reform introduced the possibility of an advance deduction for family companies whose articles of association contain clauses typical for such family companies. However, this is only applicable if the provisions in the articles of association were already incorporated two years before the relevant transfer and if they are not revoked for 20 years thereafter. Therefore, it is highly recommended that family companies examine their articles of association and incorporate the appropriate clauses, if they are not in place

already. All the above-mentioned exemptions from gift and inheritance tax are the subject of ongoing political criticism. A narrowing of these exemptions in the near future or even the introduction of a flat tax is not unrealistic, but difficult to predict.

iii Tax treatment of trusts

Trusts are generally not recognised in Germany (see Section IV.iii). Trusts can, however, trigger inheritance and gift tax in several ways. The establishment of a trust by residents (see Section II.i) or of a trust comprising assets located in Germany is considered to be a transfer of assets that is taxable in accordance with 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 ultimately clarified by the courts.

In addition, corporate tax can be triggered 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 Controlled foreign company rules in Germany: Sections 7 to 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 Sections 7 to 14 of the Foreign Tax Act (AStG) and are still subject to comprehensive changes. The EU's Anti-Tax Avoidance Directive has obliged all Member States to implement a minimum standard for additional taxation in national tax law. In Germany, the new foreign tax law has applied since 1 January 2022. The CFC rules extend the 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. This control concept was abolished and replaced by a shareholder-based control concept. Natural persons or legal entities may now control the intermediate company alone or jointly with other 'related parties'. The foreign corporation has to be an intermediate company that 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. In exceptional cases, a specific burden calculation has to be made to determine low taxation. Passive income is harmless if it does not exceed 10 per cent of the gross income of the intermediate company or €80,000. Income that meets the 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 its 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. A substantial economic activity exists if the necessary equipment and personnel are available. In addition, the economic activity must be carried out independently by qualified personnel. Furthermore, the taxpayer is obliged to provide evidence and information has to be exchanged between Germany and the Member State of the EU or the European Economic Area.

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 will 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 set up 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 state what share each heir receives subject to forced heirship rules. Additionally, an individual can make a legacy; that is, a person can be empowered to make a claim against the heirs, without being an heir himself 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. Additionally, formal requirements for a will are laid down in Article 27 of the EU Succession Regulation. 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 accrued gains, 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 hypothetical 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 acquiring assets that are situated abroad and that German succession law does not govern. The 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 old conflict of laws rules in Germany, 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 on the date of his or her death.

For successions as of 17 August 2015, new conflict of laws rules apply because of the EU Succession Regulation. They are valid in all EU Member States except Denmark and Ireland. The Regulation is not only applicable to cross-border inheritances within the EU, but also to cases with links to third countries (e.g., US citizens with their habitual abode in a Member State). 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 through a will or a joint will, or by conclusion of an agreement regarding succession.

In addition, provisions on legal jurisdiction, recognition and enforcement of decisions and authentic instruments and on the European Certificate of Succession are part of the Regulation. As a general rule, the jurisdiction will be determined by the habitual abode at the time of the individual's death.

The EU Succession Regulation is not applicable to trusts; hence, the respective national conflict of law regime applies.

IV WEALTH STRUCTURING AND REGULATION

i Commonly used structures

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. The corporate tax amounts to 15 per cent plus the solidarity surcharge (see Section II.i). In addition to corporate tax, a trade tax is also levied. The trade tax due depends on the rates determined by the local authorities. A participation exemption may apply, however, for dividends and capital gains. Profits distributed to shareholders of the corporation are subject to withholding 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 on 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 applicable). 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 are 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 a 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 real estate 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 subject to gift tax. Income tax may be triggered as well. The classification of the tax bracket depends on the relationship between the founder and the beneficiary.

In contrast to German family foundations, foreign family foundations are not liable to pay substitute inheritance tax. Further, according to a recent ruling of the German Federal Fiscal Court,[2] distributions from foreign family foundations to German resident beneficiaries are only subject to gift tax if they do not comply with the statutory purposes of the foundation or if the beneficiaries have an enforceable entitlement to distributions. However, the undistributed income of a foreign family foundation may be attributed to the personal income of the founder or the beneficiaries if they are resident for tax purposes in Germany (Section 15 AStG). This attribution taxation does not apply to family foundations that have their seat in a Member State of the EU or the European Economic Area if the foundation's assets are legally and effectively separated from the beneficiaries' property and a treaty regarding mutual administrative assistance exists between Germany and the state in which the foundation has its seat. These conditions have to be satisfied cumulatively.

2 II R 6/16.

Comprehensive changes will be applied in the law of foundations in the near future. At the end of June 2021, the German Parliament and the Federal Council passed the reform of the law on foundations. The two main objectives of the reform are to bundle the hitherto federally fragmented foundation law in a uniform and conclusive manner in the German Civil Code and to establish a centrally managed foundation register.

The new regulations came into force on 1 January 2023. The public foundation register will be introduced on 1 January 2026.

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.

Last year's decisions by the German Federal Fiscal Court on matters of inheritance and gift tax with regard to foreign trusts resolved some previous ambiguities about the gift tax treatment of trusts in Germany. The Court has clarified and confirmed criteria under which a trust qualifies as opaque or transparent for inheritance and gift tax purposes. The crucial factor is how much power over the transferred assets still lies with the settlor. Generally speaking, a trust is transparent if the settlor can access its funds or assets like his or her bank account. Transparent trusts are effectively considered non-existent by German tax law. Therefore, the trust's assets are attributed to either the settlor or the beneficiaries (depending on the specific circumstances). Consequently, upon their deceasing, inheritance and gift tax is levied on the trust's assets. Opaque trusts, on the other hand, are treated similarly to foreign foundations.

For income tax purposes, distributions made by an opaque trust are treated as capital income (similar to dividends). An additional gift tax may only be levied if distributions are made in violation of the provisions of the trust deed or if the recipient is legally entitled in any way to receive the distributed funds (i.e., has a claim to receive distributions as a beneficiary or remainderman). In such cases, trust distributions may trigger both inheritance and gift tax and income tax.

V CONCLUSIONS AND OUTLOOK

The German legal and tax system offers some flexibility for private wealth and estate planning. If structured appropriately, the taxpayer can take advantage of certain relief mechanisms for the succession in family-owned businesses. In particular, flexibility was gained when the EU Succession Regulation came into effect.

Usually, corporations and partnerships are used to structure assets and transfer them to the next generation. Family foundations and charitable foundations may be considered an alternative instrument in estate planning 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.

Especially for internationally mobile persons, German income tax law as well as inheritance and gift tax law give rise to a number of 'traps' with sometimes drastic consequences.

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