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The Taxation of German Settlors, Beneficiaries and Remaindermen of US (and non-US)Trusts

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A. Private Law Framework

I. Recognition of Common-Law Trusts (Private International Law Rules)

The concept of a trust is unknown in German civil law. This makes German/Anglo-American estate planning difficult. The German treatment of trusts is typically determined by analogizing the trust in question to some other legal arrangement recognized under German law.

(1) Testamentary Trusts

A testamentary trust is a legal institution under the law of succession. Therefore, it is subject to Article 25(1) EGBGB (Introductory Act to the Civil Law Code). All legal questions and legal succession mortis causa are governed by the nationality (not residence) of the decedent/settlor until August 17, 2015. The reference given is a reference to foreign law including its conflict-of-law principles.

From August 17, 2005 the EU directive on succession applies meaning that in principle the law of the domicile of the deceased applies. The testator has the right to opt for the laws of his citizenship in his last will.

(2) Inter Vivos Trusts

Two different views are taken in Germany with respect to inter vivos trusts. According to one view they are legal institutions similar to a contract for debt (Schuldvertrag)[1], in which case the principles of the international law of contracts for debt will be apply. Thereby, an inter vivos trust could also be created by German nationals serving as settlors. Another more restrictive view consid-

[1] Art. 27 et. seq. EGBGB.

ers the trust to be a legal institution under corporate law, in which case the link will be the same as under international corporate law.

(3) Trust Assets

The question as to whether or not specific assets may be effectively made part of the trust assets must be examined separately. This is a legal issue which is subject to the relevant conflict of law rule governing all legal questions in rem.

As regards German property, this means that assets may only become trust assets if the relevant legal system in rem offers such a provision. Under German property law, the numerus clausus of the rights in rem applies. The Federal Supreme Court ruled in 1985 that a legal trust relationship is incompatible with German public policy for structural reasons[2]. An effective legal trust relationship may not be created with respect to the assets being subject to German property law. German assets (e.g., claims governed by German law, German shares in business enterprises, real estate) may not effectively become trust assets under civil law.

(4) Forced Heirship Rights and Trusts

If the German law of succession is applicable, the trust must be compared with the German law on forced heirship rights. The transfer of property to a trust in which the trust settlor is the beneficiary must be assessed, economically, as the making of a gift while retaining a usufruct right (*Nießbrauch*) for the benefit of the donor. The consequence thereof is that such transfer will be deemed insignificant and that the assets will increase the inheritance in terms of the law on forced heirship rights, when calculating the monetary claim under Sec. 2303 et. seq. German Civil Code (*BGB*). These rules may apply in the event a German living in the US creates inter vivos trusts like GRATs, GRITs or GRUTs. Revocable trusts will likewise be treated as ineffective for structuring

[2] Judgment of the German Supreme Court dated 13 June, 1984, published in IPRax 1985, 22 et. seq., 23.

(e.g. a Grantor Trust). These rules also apply for claims under the German statutory matrimonial property regime of the community of surplus (Zugewinngemeinschaft).

(5) Civil Law Planning Recommendations

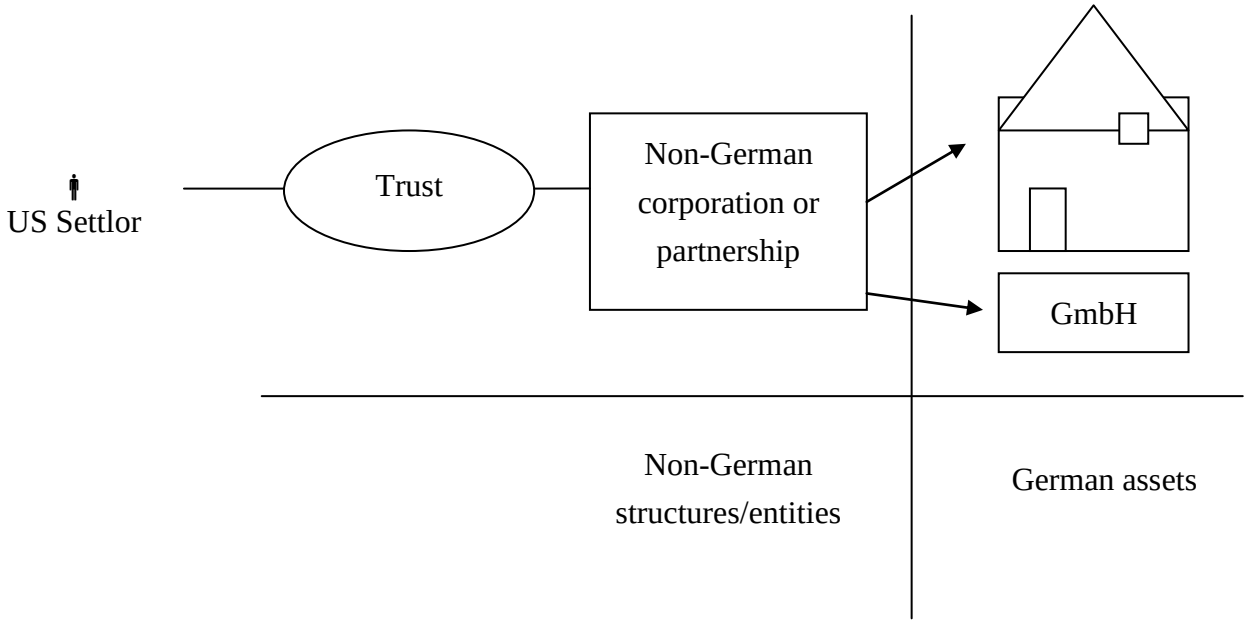
For the reasons mentioned above, the following rules should be carefully considered when advising on the creation of a trust with a German connection:

(i) If the German settlor is living in the US, the trust should be created inter vivos, and its management should be outside of Germany; in such a situation in the future also testamentary trusts may work.

(ii) If the settlor of the trust is a US citizen, problems in creating a testamentary trust or a trust inter vivos should be avoidable.

(iii) There are also no civil law problems if a German becomes a beneficiary or a remainderman in the situation described under (ii). In such a situation also, under German conflict-of-law rules, the relationship between the German beneficiary and the trustee is governed by the applicable trust laws determined by US conflict-of-law principles;

(iv) Assets governed by German law should not be transferred to the trust or if they are transferred, the structure should be done in the following way:



(v) One should also keep in mind that under German law it is not possible to circumvent forced heirship rights or marital claims under the German matrimonial property regime of the community of surplus (*Zugewinngemeinschaft*), which is the statutory German matrimonial property regime if the settlor of the trust is a German citizen.

B. Direct and Indirect Taxation of Trusts and Their Settlors, Beneficiaries and Remaindermen

I. Overview of the German Tax System

(1) Income and Transfer Taxes

Germany imposes a federal personal income tax on the worldwide income of resident individuals (Income Tax Act - ITA). Resident corporations, associations and certain segregated pools of assets are subject to federal corporate income tax (Corporate Income Tax Act - CITA). In addition to federal income taxes, municipalities are authorized to levy a local trade tax on the profits of commercial enterprises owned by individuals, partnerships and corporations (Trade Tax Act - TTA).

Transfers at death and gratuitous transfers are subject to the federal inheritance and gift tax (Inheritance and Gift Tax Act - IGTA). The federal inheritance and gift tax code contains specific provisions dealing with the creation, the distribution and the dissolution of trusts. They contain specific provisions with a penalty tax for "foreign entities aimed at the binding of assets". Also, the German Foreign Tax Act (FTA) contains a specific provision dealing with foreign family foundations and family trusts and imposes a specific income taxation on the undistributed income of such tax entities.

(2) Basic Inheritance and Gift Tax Principles

Germany imposes an inheritance tax on the transfer of property at death. Unlike an estate tax that subjects the decedent's estate as a whole to taxation, the inheritance tax looks at the accretion of each individual heir's wealth or at their enrichment. Accordingly, each heir is ultimately liable for tax on his or her individual share of the estate. The inheritance tax also takes into account the family relationship between the decedent and the heirs. § 15 IGTA defines three classes of transferees that are eligible for varying personal exemptions and preferential rate structures, depending on the closeness of their family relationship to the decedent. The decedent's wife, children, grandchildren form class I and enjoy the highest exemption amounts and the lowest tax rates. By contrast, taxpayers in class III are entitled only to a very small personal exemption, and the top tax rate is 50 % for taxable transfers in excess of EUR 6,000,000.

The gift tax is levied on gratuitous transfers by one taxpayer to another taxpayer. Like the inheritance tax, it is based on the concept of accretion of wealth or enrichment. Under the enrichment doctrine, only transfers that are not contingent on future events and that result in a present benefit to the transferee are taxable. While the income tax employs factual criteria such as so-called economic ownership (beneficial ownership) in addition to legal criteria to identify taxable transfers, the inheritance and gift tax takes a more formal approach. As a rule, a taxable transfer requires that the transferee obtain legal title to the property or at least an enforceable claim under private law. The gift

tax complements the inheritance tax. Under § 14 IGTA, gratuitous transfers and transfers at death by an individual to the same recipient within 10 years are aggregated into one transfer . § 15 IGTA also applies to gratuitous transfers and combinations of gratuitous transfers and transfers at death within the ten-year time limit of § 14 IGTA. In 1999 Germany amended the Inheritance and Gift Tax Act to deal with transfers to and from foreign trusts.

The rate of tax therefore depends on the relationship between the donor and the donee and the amount given by that donor to that donee. The following tax-free allowances are available (§ 16 IGTA):

	Relationship to donor/ decedent	Allowance
Tax class I	Spouse	500,000
	Child or stepchild	400,000
	Grandchild	200,000
	Other descendant or (in the case of inheritance, upon death) parent or grandparent	100,000
Tax class II	(parent or grandparent in the case of a lifetime gift, sibling, niece or nephew, stepparent, son- or daughter-in-law, mother- or father-in-law, former spouse)	20,000
Tax class III	Other (like trusts)	20,000

If neither the donor nor the donee has a place of residence or habitual abode in Germany, the tax free allowance is limited to EUR 2,000.

After deducting the tax-free allowance, the tax rate applicable to the gift of inheritance is as follows (§ 19 IGTA)

Amount of gift/ inheritance	Tax rate (per cent)		
	Tax class I	Tax class II	Tax class III
Up to € 75,000	7	15	30
€ 75,000 - € 300,000	11	20	30
€ 300,001 - € 600,000	15	25	30
€ 600,001 - € 6,000,000	19	30	30
€ 6,000,000 - €13,000,000	23	35	50
€ 13,000,001- € 26,000,000	27	40	50
More than € 26,000,000	30	43	50

(3) Basic Income Tax Principles

Basic income tax principles, as far as they are relevant for this overview, will be explained within the context of trust-specific issues.

II. Inheritance and Gift Tax

(1) Case Law Prior to 1999

Prior to 1999 the Federal Finance Court ruled repeatedly that setting up a testamentary trust did not trigger inheritance tax.[3] In accordance with the enrichment doctrine, the Court held that the transfer of property to the trustee did not result in a taxable transfer to the beneficiaries because the beneficiaries did not acquire legal title to the trust property. The mere fact that they could ex-

[3] Decisions of December 20, 1957, BStBl. III 1959, 79, May 31, 1961, BStBl. III 1961, 312, May 7, 1986, BStBl. II 1986, 615, BFH/NV 1990, 235.

pect future benefits was not sufficient to constitute a present taxable transfer under private law. The trustee, in turn, was not liable for inheritance tax either because he was a fiduciary who did not benefit from the transfer. The trust as such was not a legal entity and could not be treated as a taxpayer for inheritance and gift tax purposes. Most commentators took the position that case law also applied to the creation of inter vivos trusts. Consequently, the gratuitous transfer of property to a trust did not qualify as a gift and thus was not subject to gift tax.

Case law created an opportunity for inheritance and gift tax planning. By setting up a trust under foreign law, wealthy families could defer the inheritance tax that otherwise would have arisen upon the death of the transferor until the day the beneficiaries and/or remaindermen actually received payments from the trust. What is more, trust arrangements were utilized for generation-skipping transfers that eliminated the inheritance tax burden for one or more generations of a family.[4]

(2) 1999 Amendment of the Inheritance and Gift Tax Act

The IGTA was amended in 1999 to close the inheritance tax loophole for trusts.[5] Although the amendment does not use the term "trust", it is clear from the legislative materials that the amendment was primarily intended to deal with transfers to and from foreign discretionary dynasty trusts.[6] The statutory language is intentionally broad so as to cover a wide array of possible trust arrangements. As a result, a large part of the legal discussion of the classification of foreign trusts for purposes of the inheritance and gift tax has become moot. The new legislation expressly addresses the creation of a trust, the distribution of income from a trust and the dissolution of a trust.

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4 *Habammer*, DStR 2002, p. 425, 430.
5 *Wienbracke*, SteuerRevue 2007, p. 409.
6 BT-Drucks. 14/23, dated November 11, 1998, p. 200.

(3) Creation of a Trust

a) Testamentary Trust

aa) Inheritance Tax

Under § 3(2)(1) IGTA, the creation of a testamentary trust by a resident of Germany is deemed to be a taxable transfer at death. The same applies if a non-resident in Germany transfers so- called *Inlandsvermögen* (domestic assets) within the meaning of Sec. 121 BewG (Valutation Act) to a foreign trust. This could be the case, for example, if a US citizen transfered German real estate via a US transparent limited partnership to a US trust.

However, the language of the statute is quite vague so it can be difficult to determine which types of trust arrangements are subject to taxation. The taxable event is defined as "an act in accordance with the testator's instructions that creates or contributes to a foreign pool of assets which has as its purpose the segregation of property".[7]

In most cases, a testamentary trust validly created under the laws of a foreign jurisdiction will fulfil the requirements of the first part of the definition as the trustee receives property according to the testamentary instructions of the decedent. Also, its purpose is to segregate property, i.e. to set aside and keep together certain assets on behalf of the beneficiaries and the remaindermen of the trust; for example, a dynasty trust set up for US generation-skipping tax purposes would clearly fulfil the criteria.

On the other hand it is questionable whether this type of taxation can apply to testamentary trusts created within a will of a German domiciliary, due to the reasons mentioned in I. A. (1).

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[7] The statutory language resembles the terminology used by § 2(1) CITA. Therefore, it has been argued that a foreign pool of assets that is classified as a taxable entity under § 2(1) CITA is also a "taxable trust" for purposes of the inheritance gift tax; *von Oertzen*, DStR 2002, 433.

It is also unclear whether the German trust taxation also applies in cases where inter vivos revocable trusts become irrevocable upon the death of the settler, and the trust has as its only purpose the avoidance of probate proceedings (as is often the case in the US), and the trust arrangement is designed to distribute the assets to the beneficiaries. Here one can argue that the trust has no dynastic function, and therefore the German taxation rules for foreign trusts with German beneficiaries should not kick in. Instead, the beneficiaries would be taxed with their distributions from the trust in the relationship which existed between the trust settlor and the beneficiary. The situation should be similar to the taxation of a US estate with German beneficiaries without a trust[8].

bb) Trusts as Taxpayers

The amended Inheritance and Gift Tax Act does not dwell on the issue of whether a trust is a legal entity or not. § 20(1)(2) IGTA flatly states that the foreign pool of assets as such is liable to inheritance tax. By contrast, the trustee, beneficiaries and remaindermen are not liable for tax for the reasons stated in the Federal Finance Court's decisions prior to 1999[9]. As there is no family relationship between the trust and the decedent, the reduced tax rates for transfers to family members do not apply to the transfer of property to a testamentary trust. The trust is a category III taxpayer, and the tax rate ranges from 30% to 50% ,depending on the value of the property. The strict denial of reduced rates for intra-family transfers is somewhat surprising from a tax-policy perspective as § 15(2) IGTA allows preferential treatment of transfers to certain domestic "family foundations", i.e. foundations situated in Germany, primarily for the benefit of a specific family or specific families.

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8 Decision of June 8th, 1988, BStBl II 1988, 808: In the event of a US estate governed by US laws, the beneficiaries are taxed in the personal relationship at the moment of death of the decedent, although the executor of the respective US estate has not paid out and will not pay out the assets of the estate to the beneficiary in the short term.

9 The situation is more complex if the trust is not a discretionary trust but a fixed interest trust (see also the discussions about QDOTs with German beneficiaries).

By treating a foreign pool of assets as a taxpayer, § 20(1)(2) IGTA raises a number of enforcement and tax collection issues. While the local tax office has authority under § 20(1)(2) IGTA to assess inheritance tax on the transfer of property to a trust, it is not clear whether the tax assessment and the payment order are enforceable if the trust property is located in a foreign jurisdiction. In addition, the local tax office may even bring a claim against the trustee, who is not a taxpayer pursuant to § 20(1)(2) IGTA but may be personally liable as a representative of the trust pursuant to § 69 of the Tax Procedure Act.[10]

b) Inter Vivos Trusts

Depending on the type of trust arrangement, the creation of an inter vivos trust by a resident of Germany may result in a taxable gift under § 7 IGTA. § 7 IGTA contains a catalogue of taxable gratuitous transfers that are subject to the gift tax. Pursuant to § 7(1)(8) IGTA, which is very similar to § 3(2)(1) IGTA, "the creation or contribution to a foreign pool of assets which has as its purpose the segregation of property" is deemed to constitute a taxable event.

aa) Fiduciary Arrangements

If the settlor retains control over how the property in trust is used, and if he has the right to terminate the trust at any time and without any restrictions, the creation of the trust is not a taxable event. Under the general tax doctrine of beneficial ownership (§ 39 Tax Procedure Act), the property in trust is attributed to the settlor even though the trustee acquires a legal title to it.[11] From the German perspective, this type of trust is classified as a fiduciary arrangement under which the trustee merely has the function of an asset manager. As the economic risks and rewards connected with to the property remain with the

[10] *Habammer*, DStR 2002, 425, 431.

[11] It should be mentioned that the concept of so-called economic or beneficial ownership is not a general inheritance and gift tax concept. There seems to be agreement, however, that the creation of a legal arrangement that qualifies as a "fiduciary arrangement" pursuant to § 39(2) Tax Procedure Act is not a taxable transfer.

settlor, the transfer of legal title is irrelevant for gift tax purposes. This should be the case if the settlor creates a Grantor Trust. The Fiscal Court of Baden-Württemberg, in its decision of July 15, 2010,[12] clarified that a Grantor Trust is not a creation or contribution to a foreign pool of assets which has as its purpose the segregation of property. The decision was upheld by the Federal Finance Court[13].

bb) Irrevocable Inter Vivos Trusts

By contrast, setting up an irrevocable trust results in a separation of legal title and equitable ownership and is a proof of the settlor's intention to segregate property on behalf of the beneficiaries and remaindermen. As the economic risks and benefits of the property are transferred to the trust and the trust property is no longer controlled by the settlor, the transfer of property to the trust is subject to gift tax. This interpretation of § 7(1)(8) IGTA is consistent with the legislature's intention to close the loophole that existed under the previous case law. Nevertheless, some uncertainty remains.

cc) Revocable Trusts

It has been argued that revocable trusts are comparable to fiduciary arrangements and thus not within the purview of § 7(1)(8) IGTA because the settlor has retained the right to un-wind the trust at any time.[14] However, the statutory language does not differentiate between irrevocable and revocable trusts. Even though the settlor may revoke the trust at a later time, the purpose of a revocable trust may be to segregate certain assets from the property of the settlor and to relinquish control at least temporarily. Taking into account the objective of § 7(1)(8) IGTA, taxation can be justified. If the settlor later decides to revoke the trust, the gift tax paid on the creation of the trust is refundable under § 29(1)(1) IGTA.[15] Nevertheless, these rules may only apply in

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12 EFG 2010, 162 et seq.
13 Federal Finance Court, decision of September 27, 2012, BStBl. II 2013, p. 84.
14 *Füger/v. Oertzen*, IStR 1999, 11, 13.
15 *Wienbracke*, SteuerRevue 2007, p. 409, 413.

cases where the beneficiary and the settlor are not the same persons, which, in a revocable trust situation, is not very often the case. In case settlor and beneficiary are the same person there is no "segregation of property". This was also the view of the Federal Fiscal Court in 2012[16].

dd) Gratuitous Transfers to Existing Trusts

Gratuitous transfers by the resident to an existing trust are subject to gift tax pursuant to § 7(1)(1) IGTA.

ee) Trusts as Taxpayers

§ 20(1)(2) IGTA applies not only to transfers at death but also to gratuitous transfers involving inter vivos trusts. As a consequence, the trust is deemed to be a transferee for gift tax purposes and is tax liable. The gift tax is computed by applying class III tax rates to the taxable amount as determined by a valuation of the transferred property. Treating the trust as a taxpayer for gift tax purposes raises enforcement issues very similar to those discussed above. However, the settlor is also liable for gift tax under § 20(1)(2) IGTA so the local tax office can collect the gift tax from a resident taxpayer and thus avoid possible enforcement issues.[17]

(4) Distribution of Trust Property and Trust Income

The creation of a trust does not result in inheritance or gift taxation of the beneficiaries or the remaindermen as these persons do not receive a present benefit under the accretion of wealth or so-called enrichment doctrine. This applies in any case if the trust is set up as a discretionary trust. These rules also apply if the beneficiary is entitled to regular distributions like in a fixed-interest trust. The Financial Court of Baden-Württemberg ruled that the beneficiary designation in a fixed-interest trust itself does not trigger inheritance or gift

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16 Federal Finance Court, decision of September 27, 2012, BStBl. II 2013, p. 84.
17 *Wienbracke*, SteuerRevue 2007, p. 490, 495.

taxes.[18] Only the actual distributions are taxable. This decision was upheld by the Federal Fiscal Court[19].

The distribution of trust property to the remaindermen also constitutes a taxable gift under § 7(1)(9) IGTA if the remainderman is a resident of Germany. § 7(1)(9) IGTA applies to distributions upon the dissolution of testamentary as well as inter vivos trusts. It also applies to distributions of property from a trust that continues to exist, although the statutory language may imply otherwise. The wording of § 7(1)(9) IGTA is as follows: "Transfers upon the dissolution of a foreign pool of assets, having the purpose of segregating property, as well as transfers to intermediate beneficiaries during the existence of the pool of assets … are deemed to be a taxable gift." Although the term "intermediate beneficiaries" is not defined, the majority of commentators construe it to include any distribution of trust income or trust property to any beneficiary or any remainderman during the existence of the trust. This is also the view of the Federal Fiscal Court[20].

As a result, trust property that was subject to inheritance or gift tax when it was transferred to the trust will be subject to a second level of gift tax when it is distributed to the remaindermen. In addition, trust income that is not retained by the trust but distributed to beneficiaries who are residents of Germany will also be subject to gift tax regardless of any income tax that might be imposed on the income.[21] § 7 (1)(9) IGTA applies to distributions of income from discretionary trusts.[22] § 7 (1)(9) IGTA also applies to distributions of income from fixed-interest trusts (see above).

It is clear that the gift tax arises on the actual receipt of trust income or trust property by the recipient of a discretionary trust.[23] In § 15(2)(2) IGTA family

[18] FG Baden-Württemberg, EFG 2011, 160.
[19] Federal Finance Court, decision of September 27, 2012, BStBl. II 2013, p. 84.
[20] Federal Finance Court, decision of September 27, 2012, BStBl. II 2013, p. 84.
[21] *Habammer*, DStR 2002, p. 425, 431.
[22] *Wienbracke*, SteuerRevue 2007, p. 490, 497.
[23] *Habammer*, DStR 2002, p. 425, 431.

relationships are taken into account in determining the applicable tax rate. Depending on their proximity to the decedent or settlor, beneficiaries and remaindermen can qualify for either class I or class III of the gift tax rate system. However, the determination of the tax rate class can pose difficulties if the trust property was contributed by different persons. The Fiscal Court of Baden-Württemberg, in its decision of July 15, 2010,[24] clarified that any distribution from a grantor trust to the grantor, and the termination of the grantor trust and repayment of trust corpus to the grantor do not trigger German inheritance and gift taxes. This decision was upheld by the Federal Fiscal Court.

(5) Backup Inheritance Tax

§ 1(1)(4) IGTA imposes a so-called backup inheritance tax on certain domestic family foundations. The backup inheritance tax arises in thirty-year intervals. Its objective is to subject family foundations to inheritance tax that would otherwise remain untaxed due to their perpetual existence. The backup inheritance tax does not apply to foreign trusts.[25]

(6) The US/German Estate and Gift Tax Treaty

a) Article 12 DTT

Article 12 of the U.S./German Estate and Gift Tax Treaty contains special provisions for trusts. In Article 12(1) both contracting states reserve the right to apply their respective rules governing the recognition of a taxable event with respect to transfers of property to and from trusts. Article 12(3) provides that "*in a case where a transfer of property to a trust results in no taxable transfer at such time under the German inheritance and gift tax, the beneficiary of the trust may elect within five years after such transfer to be subject to all German taxation (including income taxation) as if a taxable transfer had occurred to him at the time of such transfer*".

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[24] EFG 2010, 164

[25] *Wienbracke*, SteuerRevue 2007, p. 490, 502.

The election was necessary to avoid double taxation prior to the 1999 amendment to the Inheritance and Gift Tax Act. Under the old rules, the creation of the trust was not a taxable event and inheritance tax was imposed on later distributions to beneficiaries and remainderman. In many cases, U.S. estate tax could not be credited against the inheritance tax due to a five-year limitation on creditable foreign estate and inheritances taxes under § 21(1)(4) IGTA.

Habammer, a member of the German Finance Administration, takes the position that the election under Article 12(3) is irrelevant for transfers after 1999 because the creation of a trust is subject to taxation in the U.S. and in Germany in the same year.[26] Other commentators point out that gift tax will arise on later distributions to beneficiaries and remainderman so there is still a need for the election.[27]

In the established practise of the German revenue service, the option provided by Art. 12 (3) is available for a German beneficiary of remainderman in cases where Germany did not have the right to tax the creation of the trust under the treaty, e.g. if a US citizen domiciled in the US is creating in his will a US testamentary trust with its seat in the US with non German assets.

This election right is a very powerful planning tool, especially when taking account of the higher US transfer taxes compared to their German counterparts when assets are transferred within in the family. Usually, the credit of US transfer taxes against German transfer taxes lead to the result that no German transfer taxes are due anymore.

It is unclear whether Art. 12 Sec. 3 Estate Tax DTT also applies to distributions from the trust to the beneficiary in case where they have elected to be treated as if they had acquired the trust assets outright. *Jülicher*[28] is of the opinion that in cases where a German beneficiary has elected under Art. 12

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[26] DStR 2002, 425, 432.
[27] *von Oertzen*, DStR 2002, 433; Debatin/Wassermeyer/*Hundt*, Art. 12 DBA-USA/E, annot. 47 et seq.
[28] *Jülicher*, IStR 2001, 178 ff.

Sec. 3 Estate Tax DTT that distributions from the trust to the German beneficiary or remainderman are no longer to be subject to German gift taxes, the result of this specific election right is that, for gift tax purposes (concerning income taxes see B. (8)), the beneficiary is treated as if he would own the assets outright. Then distributions to him are not gift taxable. Nevertheless, caution should be taken when making use of this election right, especially when it is planned that trust assets should not be distributed to the German beneficiary. In cases where a beneficiary passes away, one could be of the opinion that for inheritance tax purposes he is then treated as if he was owner of the trust assets which he then at the moment of death returns to the trust so that the German special inheritance creation tax for foreign trusts would be applicable. This problem has thus far not been debated in German literature. I am of the opinion that this is not the case because the German creation tax for foreign trusts only applies when assets are transferred to a trust. Here in this situation, only the fictitious ownership ends, but there is no transfer of legal title. Under German gift and inheritance tax principals, only an enrichment of a trust can be taxed. As no enrichment occurs, the trust assets should not be treated as being taxable part of the estate of the deceased German beneficiary. Nevertheless, a private letter ruling is recommendable when making use of the election right of Art. 12 sec. 3 DTT.

b) The 10 Year Rule of Art. 4 Sec. 3 DTT

In the tie-breaker rules of the US/German Estate and Gift Tax Treaty, it is said that if an individual, at his death or upon the making of a gift, was (i) a citizen of one contracting state and not also a citizen of the other contracting state and (ii) by reasons of the provisions of § 1 (of Art. 4) domiciled in both contracting states and (iii) by reasons of the provisions of § 1 (of Art. 4) domiciled in the other contracting state for not more than 10 years, then the domicile of that individual and of the members of his family forming part of his household and fulfilling the same requirements shall be deemed, notwithstanding the provisions of § 2 (of Art. 4), to be in the contracting state of which they were citizens.

This means that a US citizen coming from the US to Germany is protected against German estate and gift taxation on their worldwide estate during their first 10 years in Germany if (i) the beneficiary/heir is domiciled in the US and no German real estate or business assets are transferred to him or (ii) the beneficiary/heir is a US citizen who has been living for fewer than 10 years in Germany in the same household as the testator and no German real estate or business assets are transferred to him.

This means that trust strategies for liquid assets in the first 10 years for US citizens after coming to Germany are still viable and must not be amended. Nevertheless, this is only the case if the trust qualifies for US and German tax purposes as a US trust.

On the other hand this also means that a German citizen coming from Germany to the US is exposed to the German trust taxation for inheritance and gift taxes on his worldwide estate although he may have already become domiciled for US transfer taxes in the US. Therefore, Germans in their first 10 years in the US should avoid using trusts or should only use trusts which do not qualify under the German inheritance and gift tax rules as trusts within the meaning of special trust taxation in Germany (like a Grantor Trust). Nevertheless, if they created a Grantor Trust, then passed away within their first 10 years in the US, the German special taxation rules for trusts would apply and would lead to very high German taxes.

The application of Art. 4 Sec. 3 DTT can also be beneficial to incoming US heirs or donees who receive payments from US trusts because, some years ago, the Berlin revenue service issued to me a private letter ruling that a US citizen living in Germany for fewer than 10 years but receiving distributions from US trusts is protected under the US/German Estate and Gift Tax Treaty due to Art. 4 Sec. 3 DTT from the German specific trust taxation. Only the German income taxation remains.

c) Art. 10 Sec. 6 DTT and the Need for QDOTs for German Surviving Spouses

Due to Art. 10 Sec. 6 of the US/German Estate and Gift Tax Treaty, the surviving German spouse of a US citizen is entitled to a special martial deduction for US estate- tax purposes if (i) at the time of a decedent´s death, the decedent was domiciled in Germany or the US, (ii) the surviving spouse was at the time of the decedent´s death domiciled in either Germany or the US, (iii) if both the decedent and the surviving spouse were domiciled in the US at the time of the decedent´s death and one or both were German and (iv) the executor of the decedent's estate elects the benefits of Art. 10 Sec. 6 of the US/German Estate and Gift Tax Treaty and waives any benefits of any other estate tax marital deduction that would be allowed under US laws on the US estate tax return filed for the decedent´s estate by the date on which a QDOT election could be made under US laws. Therefore, Art. 10 Sec. 6 currently gives the German spouse of a US citizen a very high US tax allowance.

Another way to avoid the need for a QDOT would be if the German surviving spouse becomes a dual citizen during lifetime of the US spouse or before filing the US estate tax return.

d) Overview on the Right of Taxation and the Tax-Credit System Between US and Germany Under the DTT

Right to tax U.S.A. / Germany						
Residence of decedent	**Nationality of decedent**	**Residence as per Article 4**	**Heir**	**Right to tax**	**Special provisions**	**Tax credit system**
G	irrelevant	G	G	G	USA: Real estate/ business assets	Credit of US tax in G with respect to real estate/business assets in the US (Art. 11 para. 3 sub-paragraph a))
USA	irrelevant	USA	USA	USA	G: Real estate / business assets	Credit of German tax in the US with respect to real estate/business assets in G (Art. 11 para. 2 sub-paragraph a))
G	G	G	USA	G	USA: Real estate/ business assets	Credit of US tax in G with respect to real estate/business assets in the US (Art. 11 para. 3 sub-paragraph a))
USA	irrelevant	USA	G	USA / G	-	- Credit of U.S. tax in G; exception: US tax on real estate/business assets in G (Art. 11 Para. 3 sub-paragraph a)) - Creditation of German tax in the US with respect to real estate/business assets in G (Art. 11 Para. 3 sub-paragraph a))
G	USA	G	irrelevant	USA / G	-	- Credit of German tax in the US; exception: German tax on real estate/business assets in the US (Art. 11 para. 2 sub-paragraph b)) - Creditation of US. tax in G with respect to real estate/ business assets in the US (Art. 11 Para. 3 sub-paragraph a))

/Oe/17.08.2010

(7) Inheritance and Gift Tax Planning Recommendations

(i) If a US citizen domiciled in the US creates a testamentary or inter vivos trust with US assets, this does not trigger any German inheritance or gift taxes.

(ii) In cases in which Germany does not have the right to tax the creation of a US trust, e.g. because due to treaty protection under the US/German Estate and Gift Tax Treaty the German beneficiary can elect to be treated as if he had acquired outright ownership of the trust assets. Then US transfer taxes would be credited against German transfer taxes.

(iii) Distributions from a trust (income and corpus) are gifts to the German beneficiaries and are taxed according to the relationship between the settlor and the beneficiary.

(iv) A US citizen domiciled in Germany has, for the first 10 years after coming to Germany, to a certain extent treaty protection for estate and gift

tax purposes and can receive distributions from a US trust free of German gift taxes (disputed).

(v) Germans coming to the US are, for their first 10 years in the country, still exposed to the German inheritance and gift tax when creating US trusts.

III. Income Tax

(1) Classification of Trusts

From an income tax perspective, a trust can be classified as a fiscally transparent conduit (fiduciary arrangement), as a separate legal entity that is treated as a corporate taxpayer or as a "family trust" that is subject to a special tax regime on undistributed income. There is no general rule for the classification of certain types of trusts as the courts examine not just the legal framework of a foreign trust but also the facts and circumstances of each case.

a) Fiduciary Arrangement (Conduit)

Under the doctrine of fiduciary arrangement (Treuhandverhältnis), the transfer of property by a taxpayer to another person is irrelevant for income tax purposes, if the transferee acts solely for the benefit of the transferor, is subject to strict guidelines imposed by the transferor, and if the transferor is empowered to terminate the fiduciary arrangement at any time. A trust that fulfils these criteria is likely to be treated as a fiscally transparent conduit.[29] The trust property is attributed to the settlor, and the trust's items of income and deductions are included in the taxable income of the settlor. This is the case in case of a grantor trust.

[29] *Seibold*, DStR 1993, 545, 546; *Habammer*, DStR 2002, 425, 427; BFH decision of November 5, 1992, BStBl. II 1993, 388, 390.

aa) Revocable Trust

According to these strict criteria, a revocable inter vivos trust will not automatically be classified as a conduit merely because the settlor can revoke the trust and thus regain ownership of the property.[30] The taxpayer is also required to show that he is in control of the trust property during the existence of the trust as discussed above. If the beneficiaries and/or remaindermen have control over the trust property, the trust income will be taxed to them. In practice, however, the latter is not likely to happen as an arrangement under which the beneficiaries and/or remaindermen control the trust property would probably not qualify as a trust under foreign law.

bb) Irrevocable Trust

By contrast, an irrevocable trust will, with a very high probability, never be treated as a conduit as neither the settlor nor the beneficiaries have the authority to terminate the trust at any time.[31] This is also true with respect to a testamentary trust that is irrevocable by definition.

b) Trust as Separate Legal Entities and Taxpayers

A trust that is not classified as a fiduciary arrangement will be treated as a so-called entity taxpayer pursuant to § 1 or § 2 Corporate Income Tax Act. Corporate income tax is not only imposed on foreign entities that are taxpayers in their countries of residence and comparable to domestic corporations such as publicly or privately held corporations or domestic associations, but it is also imposed on domestic or foreign pools of assets (*Vermögensmassen*) if the pool of assets – without being a separate legal entity under domestic or foreign law – is deemed to have an independent economic existence. In two landmark decisions dating back to 1992, the Federal Finance Court held that a trust created under the laws of Jersey and a US testamentary trust will be treated as a

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30 *Habammer*, DStR 2002, 425, 427; *Seibold*, DStR 1993, 545, 547.
31 Federal Finance Court, decision of February 2, 1994, BStBl. II 1994, p. 727.

corporate taxpayer pursuant to § 2(1) CITA if the trust property consists of a pool of assets set aside for a specific purpose, is no longer controlled by the settlor and independently generates income. The rationale behind this decision is obvious: While the settlor has disposed of the property and the (future) income in a way that prevents the attribution of property and income to him, the trustee who owns and manages the property does not enjoy the benefits of ownership and thus cannot be taxed on the income either. If income tax law were to tolerate this type of tax planning arrangement, the income generated and accumulated by the trust would end up in a fiscal "no-man's land" and escape taxation.

Moreover, if the place of effective management of the trust is situated in Germany, the trust will be taxed on its worldwide income (so-called unlimited tax liability [unbeschränkte Steuerpflicht] pursuant to § 1(1) CITA). Otherwise only income from German sources is subject to taxation under § 2(1) CITA. A trust does not only have business income like a corporation but can, like an individual, also have private income.

The rules discussed above apply to discretionary trusts as well as to fixed-interest trusts. One could argue that there is no need to treat a fixed interest trust as a taxpayer pursuant to § 2(1) CITA because the trust's income is distributed to the beneficiaries on an annual basis and thus subject to income tax in the hands of the beneficiaries. However, the attribution of trust income to the beneficiaries would not be consistent with the attribution of income doctrine which requires either a contractual relationship between the taxpayer and the debtor or an active role of the taxpayer in the management of the income-producing asset. The beneficiaries do not meet these criteria as the trustee enters into contracts and is responsible for managing the trust property.[32]

[32] *Seibold*, DStR 1993, 545, 546 et seq.; *Wienbracke*, RIW 2007, 201, 202. The Federal Finance Court reached a similar conclusion in a case where three U.S. testamentary trusts distributed all trust income annually to the beneficiary who was resident of Germany, decision of February 2, 1994, BStBl. II 1994, p. 727.

(2) Family Trusts Within the Meaning of § 15 FTA (Special Tax Regime for Undistributed Income)

§ 15 FTA contains a special income tax regime for foreign so-called family foundations that are not subject to taxation of worldwide income and thus could be utilized to shelter income from taxation. A foreign family foundation is defined as an entity that has neither a registered office ("Satzungssitz") nor a place of effective management in Germany and was created to benefit the members of a family. The latter requirement is fulfilled if more than one half of the foundation's property and income is set aside for the founder and/or his relatives (see § 15 (2) FTA). In § 15 (1) FTA a proportionate share of the foundation's income is included annually in the income of the settlor or those beneficiaries and remaindermen who are German residents. § 15 (4) FTA extends this taxation mechanism to foreign "pools of assets" that were set up to benefit a family as required by § 15 (2) FTA.

In a decision in the year 1992, the Federal Court of Taxation applied § 15 (4) FTA to a Jersey trust, in which the trust's income was allocated to the settlor who was still alive and a German resident[33] and in the decision of February 2, 1994, BStBl. II 1994, 727 (US testamentary trust) to the beneficiaries living in Germany. The court held that the trust had been created for the benefit of the settlor's wife and children and was thus comparable to a family foundation and subject to the special taxation regime in § 15 FTA. As a result, the trust's worldwide income was included in the settlor's income for the taxable year.

If a German resident becomes a discretionary beneficiary of a US trust and is benefited by more than one half of the trust's property and income (alone or together with other family members), the trust will qualify as a family foundation within the meaning of § 15 (2) FTA. Thus, its worldwide income will be allocated to the settlor if he is resident in Germany and will therefore be subject to German taxation. If the German resident is only a beneficiary together

[33] Federal Court of Taxation, decision dated 5 November 1992 – I R 39/92, BStBl. II 1993, 388.

with other (non-German) beneficiaries, then he is exposed to taxation on the undistributed income on a pro rata basis.

(3) Exemption for EU/EEA Trusts

§ 15 (6) FTA excludes family foundations having their registered office or place of effective management in EU/EEA member countries from the special taxation regime, provided that (1) the trust's property is extracted from the power of disposition of the settlor and his relatives and (2) Germany and the respective state have entered into a certain exchange of information agreement.

Typically, the place of management of a trust is with the trustee. Nevertheless, when determining the place of management of a trust one should also consider the rights and duties of a protector's committee if one exists. It is a subject of debate whether or not § 15 (6) FTA is applicable to a US trust which also has a registered office or place of management within the EU/EEA.

(4) Tax Consequences and Taxation Regime pursuant to § 15 FTA

In accordance with the special taxation regime described by § 15 FTA above, which will be applicable if the place of effective management of the Trust is located in the US, property and (positive) income[34] of the US family trust are attributed to the beneficiary on a pro rata basis if the beneficiary is a German resident. As long as the beneficiary is alive and the trust income accumulates to the trust, the trust income – as determined by German tax law – is added to the taxable income of the beneficiary on a pro rata basis. The beneficiary is entitled to a foreign tax credit with respect to foreign income taxes the trust paid on the income (see § 15 (5), 12 FTA). The trust income is included in the taxable income of the beneficiary in the taxable year in which the income aris-

[34] Negative income cannot be allocated to the settlor/beneficiary, see Sec. 15 (7) sentence 2 FTA.

es under general income tax rules on level of the trust[35]. Distributions of accumulated trust income that was subject to taxation in a prior year are not taxed a second time pursuant to Sec. 20 (1) No. 9 Income Tax Act (see (5) below).

If the trust qualifies as a foreign family trust within the meaning of § 15 FTA, which is not exempt under § 15 (6) FTA, its property and income is attributed to the beneficiary on a pro rata basis and added to their taxable German income. According to § 20 (1) FTA, double tax treaties can not prevent the allocation of income pursuant to § 15 (1) FTA. However, distributions of accumulated trust income that have been taxed under § 15 FTA will not be taxed a second time, according to Sec. 20 (1) no. 9 ITA, when distributed to the German beneficiaries. Nevertheless, gift tax will arise in cases where the beneficiary has not or cannot make use of the election right provided by Art. 12 Sec. 3 US/German Estate and Gift Tax Treaty.

In German tax literature complex strategies are discussed for avoiding the adverse German tax consequences of § 15 FTA.

(5) Distributions from an Irrevocable Trust

Generally, distributions of foreign irrevocable trusts are subject to German income tax (Sec. 20 (1) no. 9 Income Tax Act, hereinafter referred to as: "ITA"). This is true with regard to periodic or ad-hoc distributions of trust income as well as to distributions of trust property (repayment of capital). Only repayments at the expense of the tax contribution account in terms of § 27 CITA are not taxable. However, trusts resident in third countries like the US cannot refund distributions at the expense of the tax contribution account[36]. Such distributions are taxed under the final flat-tax regime at a tax rate of 26.375 % (plus solidarity surcharge and, if applicable, church tax) of the fair market value of the distributed assets. Due to this law, not only income but

[35] *Rundshagen*, in S/K/K, Sec. 15 AStG marginal no. 48.
[36] See *Elser/Dürrschmidt*, IStR 2010, 79 (82).

also trust corpus is income taxable when distributed to a German beneficiary or remainderman. As mentioned above, the gift tax is also triggered.

A distribution from a foreign irrevocable trust to the German beneficiary or remainderman is not taxed under § 20 (1) No. 9 Income Tax Act if the respective income was already attributed to the German beneficiary under § 15 FTA.

(6) No Credit for German Gift Taxes on German Income Taxes and Vice Versa

Pursuant to § 35b IGTA, inheritance tax can be credited against German income tax if triggered by inheritance but not by donation. However, German tax law provides neither for a credit of the income tax paid by the beneficiary on the gift tax nor vice versa[37].

(7) The US/German Income Tax Treaty

Art. 1 Sec. (6) of the US/German Income Tax Treaty specifies that Germany is not prevented from applying the German CFC-Rules and in particular the undistributed income attribution rules under § 15 FTA to a German beneficiary. Under the treaty it is also specified that distributions from a US trust are income taxable in Germany for the resident beneficiary in Art. 21 of the Treaty. It is the German understanding of Art. 21 that the US is not entitled to impose a withholding tax on a distribution from a US trust to a German beneficiary.

(8) Influence of Art. 12 Sec. (3) US/German Estate and Gift Tax Treaty on the Income Taxation of the German Beneficiaries

It is conversely a subject of debate whether § 15 FTA-Rules and § 20 (1) No. 9 Income Tax Act also apply if the German beneficiary under the US/German

[37] *Seltenreich*, Rödl/Preißer/u.a., Sec. 7 marginal no. 10, p. 443; *Jülicher*, IStR 1999, 202; *Habammer*, DStR 2002, 425, 429.

Estate and Gift Tax Treaty makes use of the election right granted in Art. 12 Sec. (3) of the US/German Estate and Gift Tax Treaty.

I am of the opinion that it is arguable due to the wording of Art. 12 Sec. (3) that § 15 FTA, and § 20 (1) No. 9 Income Tax Act should no longer apply because the Estate and Gift Tax Treaty states that the German beneficiary is subject to all German taxation (*including income taxation*) as if a taxable transfer had occurred to him at the time of such transfer to a trust.

Then he should be taxed as if he would be an outright owner of the trust assets, and therefore all the tax exemptions and tax rules should apply for private individuals receiving outright income from these assets. This would, for example, mean that income from interest or capital gains on securities would be taxed within the favourable German "final flat tax regime".

(9) Income Tax Planning Recommendations

(i) All income or any asset which flows through an irrevocable trust is exposed for the German beneficiary not only to a gift tax but also to an income tax. German gift taxes can not be credited against the German income taxes and vice versa.

(ii) To a certain extent, US taxes borne by the trust can be credited against the German § 15 FTA tax.

(iii) If a German resident is a beneficiary of a US trust, then strategies should be initiated by the trust so that the German beneficiary is not exposed to the § 15 FTA taxation.

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