

THE PRIVATE WEALTH  
& PRIVATE CLIENT  
REVIEW

SEVENTH EDITION

Editor  
John Riches

THE LAWREVIEWS

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& PRIVATE CLIENT  
REVIEW

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# PREFACE

## I INTRODUCTION

As I reflect on the developments of the last 12 months, the overriding theme is that of continuing regulatory change in the private wealth arena. A sense of increasing pace and convergence in particular stand out in comparison with earlier years.

The pace component is best seen in the introduction of new regimes or the updating of existing rules. The theme of convergence is based upon how centrally significant the concept of ‘beneficial ownership’ is becoming to many of the initiatives. A third strand is an increasing divergence between the European Union and the United States in this arena: the European Union continues to force the pace on transparency, while the United States proceeds at a much more leisurely speed and gives greater weight to privacy concerns than its European neighbours.

Clients whose assets are fully declared and are in compliance with their tax obligations are becoming increasingly sensitive to the massive complexity and increased regulatory burden that falls upon service providers and the attendant costs that they are obliged to meet. This is leading to a mindset in which additional elements of complexity in asset-holding structures are being viewed with a greater degree of scepticism. In some cases, it is also leading to a review as to whether existing structures, whether trusts or holding companies, are still the best means of achieving the family’s objectives and warrant additional cost and regulation.

While these compliant families fully understand the need for transparency to tax and regulatory authorities, there is growing concern about the pressure for public disclosure in the context of beneficial ownership registers when the disclosure relates not to businesses that trade and engage with the public at large, but to family asset-holding structures.

A review of the preamble to the EU’s Fifth Anti-Money Laundering Directive (5 AMLD) shows that, while apparent lip service is paid to respecting an individual’s right to privacy, the argument that greater public or quasi-public access to information with respect to many private asset-holding structures is required to combat the fight against terrorism and money laundering appears to hold sway. The fact that any private asset-holding structure of this type will be obliged to provide comprehensive and detailed beneficial ownership information to regulated service providers such as banks, trust and corporate service providers, legal advisers and accountants is not regarded as sufficient by EU policymakers.

5 AMLD also exemplifies a mindset in which those whose family structures (such as trusts and foundations) are managed outside the EU are subjected to a greater degree of transparency than for EU-managed structures. The rationale for this approach is that, as non-EU jurisdictions have not embraced the same degree of transparency for corporate

registers, it is necessary to render the entities that hold assets with an EU connection, such as real estate, or those with an ongoing EU ‘business relationship’, to public scrutiny. I deal with this in greater depth below.

Tax authorities have been swift to fasten onto the increased scope of these measures. While fighting terrorism and drug-smuggling was their original purpose, they have enabled tax authorities to widen the net of information that is collected and reported on citizens who are neither terrorists nor drug barons but who hold significant wealth in complex asset-holding structures.

In the rest of this foreword, I will consider two specific areas:

- a* the Organisation for Economic Co-operation and Development (OECD)’s revised Common Reporting Standard (CRS) Commentary with a focus on trust guidance; and
- b* the wide-reaching implications of the EU’s 5 AMLD and the meaning of ‘control’ in a trust context with regard to UK and Maltese trust registers.

**i CRS Revised Handbook (April 2018) with a focus on the amendments to trust guidance**

CRS applies to trusts when:

- a* a trust is a reporting financial institution (RFI); or
- b* a trust is a passive non-financial entity (NFE) that maintains an account with an RFI.

One of the key issues under discussion under the CRS and the first version of the CRS Commentary was the status of ‘protectors’.

The CRS framework provides for reporting in the context of trustees who are RFIs to be made of persons who are treated as having an ‘equity interest’ in the trust fund. In this context, Section VIII.C.4 of the CRS states that an equity interest is held ‘by any person treated as a settlor or a beneficiary of all or a portion of the trust or any other natural person exercising ultimate effective control over the trust’.

By contrast, in relation to a trust that is a passive NFE, it is necessary to identify controlling persons in relation to the trust. In the CRS, Section VIII D.6 defines ‘controlling person’ on the basis that the expression is intended to correspond to the term ‘beneficial owner’ as described in Recommendation 10 and the interpretative note on Recommendation 10 of the Financial Action Task Force (FATF) guidance as adopted in February 2012. In the case of a trust, controlling persons means ‘settlor, the trustees, the protector (if any), the beneficiary or class of beneficiaries and any other natural person exercising ultimate effective control over the trust’.

In its FAQ issued in June 2016, the OECD took the position that, where a trust is an RFI, a protector ‘must be treated as an account holder irrespective of whether it has effective control over the trust’. This response does not address the clear distinction in the CRS itself between the holders of equity interests in a trust that is an RFI (which only includes protectors if they actually exercise ultimate effective control; see above) when contrasted with the ‘controlling persons’ definition of a trust that is a passive NFE (which includes protectors regardless of the powers they hold; see above).

The Secretariat of the OECD previously confirmed that it is their intention that protectors of trusts that are RFIs should be reported, and the FAQ was discussed in and approved by the relevant working party of the OECD.

The second version of the Commentary has amended Paragraph 253 to read:

*The Equity Interests are held by any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust. The reference to any other natural person exercising ultimate effective control over the trust, at a minimum, will include the trustee **and the protector** as an Equity Interest Holder.<sup>1</sup>*

Until the legal basis for this is made clear in the CRS treaty itself, it is considered that there is a reasonable basis for forming the opposite conclusion.

The new Commentary also provides further clarity on what reporting is required when an account is closed or a beneficiary removed:

*Where an account is closed during the year, the fact of closure is reported (in addition to any distributions made prior to closure). A debt or Equity Interest in a trust could be considered to be closed, for example, where the debt is retired, or where a beneficiary is **definitely** removed.<sup>2</sup>*

The other main amendments to the Commentary relate to the obligation to look through equity interest holders and controlling persons, which are themselves entities. Paragraph 256 has been amended to read:

*Where an Equity Interest (such as the interest held by a settlor, beneficiary or any other natural person exercising ultimate effective control over the trust) is held by an Entity, the Equity Interest holder will instead be the Controlling Persons of that Entity. As such, the trust will be required to look through a settlor, trustee, protector or beneficiary that is an Entity to locate the relevant Controlling Person. This look through obligation should correspond to the obligation to identify the beneficial owner of a trust under domestic AML / KYC procedures.<sup>3</sup>*

The new Commentary notes that, in looking through entities,

*The Controlling Persons of Passive NFE are defined in the CRS as natural persons exercising control over the Entity. The CRS definition of the term Controlling Person corresponds to the term beneficial owner as set out in Recommendation 10 and the accompanying Interpretative Note of the 2012 FATF Recommendations.*

*The identity of beneficial owner of a legal person is defined as any natural person who ultimately has controlling ownership interest which is usually defined on the basis of a threshold. Footnote 30 to the Interpretative Note to Recommendation 10 of the 2012 FATF Recommendations (as printed in March 2012) gives an exemplary ownership threshold of 25%.*

---

1 Emphasis added.  
2 Emphasis added.  
3 Emphasis added.

Although, earlier in the Commentary it notes that:

*It is important to point out that the ownership threshold for legal persons of 25% that is specified in footnote 30 in the Interpretative Note to Recommendation 10 of the 2012 FATF Recommendations (as printed in March 2012) is only indicative.*

*Should the ownership structure analysis result in doubt as to whether the person(s) with the controlling ownership interest are the beneficial owners or where no natural person exercises control through ownership interest the analysis shall proceed to identifying any other natural person(s) exercising control of the legal person through other means. As a last resort, if none of the previously mentioned tests result in identification of the beneficial owner(s), the senior managing official(s) will be treated as the beneficial owner(s).*

Various examples are given on how to look through entities. Unfortunately, the new Commentary does not cover more complex structures that had previously been raised with the OECD, such as where a purpose trust owns a private trust company.

## **ii Trust registers: implications of 5 AMLD and the meaning of ‘control’**

The key text for 5 AMLD was published in December 2017 and endorsed by a legislative resolution of the European Parliament on 19 April 2018. It was then adopted by the EU Council on 14 May 2018. On 19 June 2018, the text for 5 AMLD was then published in the Official Journal of the European Union. EU Member States must transpose 5 AMLD into their national law by 10 January 2020.

### ***Enlarged scope of registration***

4 AMLD limits the scope of trusts requiring registration on a domestic trust register in the relevant EU Member State to those that generate tax consequences; 5 AMLD widens this scope to all trusts that ‘reside or are established’ in the Member State concerned. It also applies to *fiducie*, *treuhand* or *fideicomiso* as well as to foundations (which fall within the concept of legal arrangements). In practice, in the case of trusts, this will be the place where the trustee resides and not referenced to the governing law of the trust itself.

### ***Non-EU resident trusts: registration***

There is a requirement for non-EU resident trusts to register in two instances. The proposed new Article 31(3a) of 5 AMLD, for a trust established or residing outside the European Union, reads:

*Member States shall require that the beneficial ownership information of express trust and other types of legal arrangements when having a structure or functions similar to trusts shall be held in a central beneficial ownership register set up by the Member State where the trustee of the trust or similar legal arrangement is established or resides.*

*Where the place of establishment or residence of the trustee of the trust or similar legal arrangement is outside the Union, the information referred to in paragraph 1 shall be held in a central register set up by the Member State where the trustee enters into a **business relationship** or **acquires real estate** in the name of the trust or similar legal arrangement.<sup>4</sup>*

On business relationships, the existing text of Article 3(13) of 4 AMLD, which is not amended by draft 5 AMLD, states: ‘a business relationship means a business, professional or commercial relationship that is connected with the professional activities of an obliged entity and which is expected, at the time when the contact is established, to have an element of duration.’

It is unclear what these words mean in practice. In the broader sense, they could be taken to include sourcing professional advice from a counterparty in an EU Member State. It is understood that the intent at the time 4 AMLD was finalised was to focus on ‘business trusts’. The European Union was informed at the time by STEP and other commentators that this expression did not have any well-established meaning given that the vast majority of business activity conducted in a trust context would, for reasons of liability protection, be conducted through the mechanism of underlying companies. It remains to be seen what sort of guidance will be provided on this topic. If given a wide meaning, it could mean any use of professional advisers for legal, tax accounting or investment advice within the EU could trigger a requirement to register.

So far as the acquisition of real estate is concerned, it would seem this is confined to situations of EU real estate held at the trust level alone and not where such real estate is held via an underlying entity.

The regulations make provision to allow a trust to provide evidence of registration in one Member State through a ‘certificate of proof of registration or an excerpt . . . of the register’ to avoid the need for duplicated registration.

### **Public access**

5 AMLD allows for a modified form of public access to the trust register by ‘persons who are able to demonstrate a legitimate interest with respect to money laundering, terrorist financing, and the associated predicate offences, such as corruption, tax crimes and fraud’.

At present, there is no clearly understood meaning as to what constitutes ‘legitimate interest’. The implications of the 5 AMLD preamble are, however, that NGOs and investigative journalists with anti-corruption profiles should normally be seen as being able to assert a legitimate interest. This may well be a matter where different EU jurisdictions take a variety of approaches.

There is also a requirement to interlink the various EU registers by 2021, and a requirement to provide mechanisms for the verification of data. The absence of any verification mechanism to date has been seen as a major limiting factor in the utility of beneficial ownership registers. How this verification will be policed is unclear.

The qualified public access on the basis of legitimate interest needs to be contrasted with circumstances where full public access is proposed. This is in the case of use of a non-EU holding company by a trust that either resides in an EU Member State or, it would seem, becomes registrable as a result of an EU business relationship or holding of EU real estate as noted above.

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<sup>4</sup> Emphasis added.

Article 31(4) of 5 AMLD considers the situation for trusts owning a controlling interest in a non-EU company:

*The central register shall ensure timely and unrestricted access by competent authorities and FIUs, without alerting the parties to the trust concerned. It may also allow timely access by obliged entities, within the framework of customer due diligence in accordance with Chapter II. Member States shall notify to the Commission the characteristics of those national mechanisms to ensure that the information on the beneficial ownership of a trust or a similar legal arrangement is accessible in all cases to:*

- a. competent authorities and FIUs, without any restriction;*
- b. obliged entities, within the framework of customer due diligence in accordance with Chapter II;*
- c. any person or organisation that can demonstrate a legitimate interest;*
- d. any person that files a written request in relation to a trust or similar legal arrangement which holds or owns a controlling interest in any corporate or other legal entity other than those referred to in Article 30(1), through direct or indirect ownership, including through bearer shareholdings, or through control via other means.<sup>5</sup>*

Article 30(1) is the requirement for EU companies to maintain a public register of beneficial owners. Thus, for all non-EU companies, any person can, on written request, obtain information on an EU-resident trust that controls it. It is understood at this stage that privacy may be afforded to EEA-resident companies that maintain a public register. This would mean Liechtenstein companies may not fall within the scope of sub-paragraph (d) as it is an EEA member.

It is not clear how an individual would in the first instance learn of the existence of a trust in these circumstances. There is also no recognition in these rules that non-EU companies may be subject to any form of public beneficial ownership register in their own jurisdiction (given the UK's recent proposals to extend public registers of corporate entities to its overseas territories).

### **iii The UK's position: Brexit transition**

A recent UK parliamentary report stated:

*Although these dates all fall after the UK's projected exit from the EU in March 2019, it now appears likely the Government will agree to a post-Brexit transitional period during which EU law would continue to apply in the UK as if it were still a Member State. In those circumstances, the new AMLD would have to be implemented if its transposition dates occur within that period (which, considering the Prime Minister has said the transition is likely to be "around two years", is likely to be the case for all three types of register).*

It is therefore anticipated, given the imminent application of 5 AMLD, that the United Kingdom will be obliged to comply with it, at least during the transitional period. Given that the United Kingdom has also been within the vanguard of transparency initiatives with its European neighbours, it would be unsurprising if it continued to apply 5 AMLD in some

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<sup>5</sup> Emphasis added.

form once the Brexit transition has concluded. Whether the public access component for trusts would be watered down remains to be seen. It is understood that the Labour Party advocates full public access to the UK trust register.

It is also unclear whether UK companies will be regarded as ‘non-EU’ for this purpose post-Brexit, but it is assumed they will be regarded as equivalent.

#### **iv Meaning of ‘control’ in the context of EU trust registers**

FATF 2012 Recommendations: Recommendations 10, 24 and 25 require trustees and financial institutions to identify ‘the ownership and control structure of the customer’. I now turn to the two examples of trust registers in the EU that have been implemented under 4 AMLD, the forerunner to 5 AMLD. This throws an interesting light upon the extraordinary width of whom should be regarded as a beneficial owner in the context of a trust.

Section 5(2) of the UK’s Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, which came into force on 26 June 2017, require that trustees register:

- a* a settlor;
- b* trustees;
- c* named beneficiaries;
- d* beneficiaries who have received a distribution from the trust; and
- e* anyone who exercises ‘ultimate control’ over the management of the trust.

Section 2(1)(e) Malta’s Trusts and Trustees Act (Register of Beneficial Owners) Regulations (the RBO Regulations), which came into force on 1 January 2018, require that trustees register:

- a* a settlor;
- b* trustees;
- c* named beneficiaries;
- d* a protector; and
- e* anyone exercising ‘ultimate and effective control over the trust by any means’, including any other person:
  - whose consent is to be obtained; or
  - whose direction is binding in terms of the terms of the trust instrument or of any other instrument in writing, for material actions to be taken by the trustee.

FATF 2012 Recommendation 10: financial institutions must identify ‘any other natural person exercising ultimate effective control over the trust’.

In the context of the EU’s 4 AMLD and the trust register, Her Majesty’s Revenue and Customs have stated that ‘control’ means a power (whether exercisable alone, jointly with another person or with the consent of another person) under the trust instrument or by law to:

- a* dispose of, advance, lend, invest, pay or apply trust property;
- b* approve proposed trust distributions;
- c* vary or terminate the trust;
- d* add or remove a person as a beneficiary or to or from a class of beneficiaries;
- e* appoint or remove trustees or give another individual control over the trust; and
- f* direct, withhold consent to or veto the exercise of a power mentioned above.

In the context of the 4 AMLD and the beneficial ownership register for trusts, Malta's RBO Regulations have stated that 'control' means anyone exercising 'ultimate and effective control over the trust by any means', including any other person whose consent is to be obtained; or whose direction is binding in terms of the terms of the trust instrument or of any other instrument in writing, for material actions to be taken by the trustee.

The definition of 'material actions' means the following actions or any other actions achieving the same result:

- a* the amendment of the trust instrument;
- b* the addition or removal of any beneficiary, or any person from a class of beneficiaries, or any action affecting the entitlement of a beneficiary;
- c* the appointment or removal of trustees or protectors or to give another individual control over the trust;
- d* the acceptance of an additional settlor as may be applicable in terms of the terms of the trust instrument;
- e* the change of the proper law of the trust; and
- f* the assignment or transfer of all or most of the assets of the trust or the termination or revocation of the trust.

CRS imports into the concept of 'controlling persons' a direct link to the FATF defined terms of 'beneficial owners'. The CRS Commentary states at Paragraph 132:

*Subparagraph D (6) sets forth the definition of the term 'Controlling Persons'. This term corresponds to the term 'beneficial owner' as described in Recommendation 10 and the Interpretative Note Recommendation 10 of the Financial Action Task Force Recommendations (as adopted in February 2012), and must be interpreted in a manner consistent with such Recommendations, with the aim of protecting the international financial system from misuse including with respect to tax crimes.<sup>6</sup>*

On this basis, it is highly likely that the expanded definition of control that is implicit in the UK and Maltese trust registers in an anti-money laundering context that flows from the FATF 2012 framework will, over time, result in more significant disclosure being required in a CRS tax information exchange context. This is an example of the aforementioned convergence theme (see Section I).

As a separate matter, the FATF has recently been reviewing the 2008 Guidance to Trust and Corporate Service Providers. It is possible that the amended text will also give more detailed guidance on the meaning of a 'natural person exercising effective control' in a trust context. This will have a direct impact on CRS reporting for trusts in the light of the linkage mentioned above in the CRS model treaty.

The significant extensions are most likely to impact influence exercised:

- a* by committees where, to date, it has been argued that no one individual can personally decide upon a course of action;
- b* in an indirect manner by a family individual who does not serve as a protector as such but instead has a power to appoint or remove protectors; and
- c* by those with negative 'veto' powers but without positive powers to decide upon specific matters that impact the relevant trust.

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<sup>6</sup> Emphasis added.

It could be timely, therefore, for advisers to consider whether current governance arrangements for the oversight of trusts are still 'fit for purpose' or not.

## **II CONCLUSION**

What can be said at this stage is that advisers must continue to keep themselves informed on the important changes to the regulatory and transparency arena. There is no sign that the pace of reform is slowing at this point, quite the opposite.

In the longer term, it remains to be seen whether the degree of transparency and attendant public disclosure that the EU has embraced will be adopted more widely in the rest of the developed world. It is clear that the United States has been much slower to adopt measures that override privacy in such a sweeping manner.

**John Riches**

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August 2018

# GERMANY

*Andreas Richter and Katharina Hemmen<sup>1</sup>*

## 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.

## 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. Currently, an additional solidarity surcharge of 5.5 per cent of the tax due is still being levied. This surcharge was intended to finance the German reunification of 1990. Recently, the government decided on the gradual abolition of the surcharge, with the aim of having it completely abolished by 2021; however, high-income earners will not benefit from this tax relief. As 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 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.

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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.

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 95 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 held that these obsolete valuation methods are inconsistent with the constitutional principle of equality of taxation. The reform, which has now become mandatory, could result in a significant increase of the tax burden in the future. Wealth tax has not been levied in Germany since 1997.

As a result of European directive requirements, the German government is currently making efforts to introduce an obligation to report certain tax planning arrangements to the tax authorities. This may not only affect tax advisers, but also taxpayers themselves. The details of the implementation in Germany are still pending.

## **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 as far 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 artworks, 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, so far as 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 in order 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.

### 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 CFC 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 7–14 of the Foreign Tax Act (AStG).

These 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 (in certain cases, 1 per cent may suffice). The foreign corporation has to be an intermediate company, which receives passive or tainted income instead of income from its own business activities. Passive income is defined negatively by a list of active income in Section 8 of the AStG. Cumulatively, this passive income has to be subject to low tax rates of less than 25 per cent. Income that meets both criteria is added to a resident individual's income, to the extent to which the individual holds shares in the corporation. The taxable person can choose whether the taxes paid on income received from an intermediate company in a foreign country will be deducted from the amount subject to the additional taxation in Germany or whether the foreign taxes shall be credited against the additional taxes levied in Germany. In most cases, the second alternative is advantageous for the taxable person.

A foreign corporation is not, however, supposed to be an intermediate company if, *inter alia*, its effective place of management or statutory seat is located in a Member State of the EU or the European Economic Area and if the corporation carries out substantial economic activities.

Changes to the CFC rules are also expected in the foreseeable future. Sections 7 to 14 of the AStG are currently being revised by a special task force of the German tax authorities with the aim to modernise, as some of the regulations are over 30 years old. Adjustments are, furthermore, required with regard to the European Anti Tax Avoidance Directive.

### III SUCCESSION

#### i Wills

According to Section 2064 et seq. and 2229 et seq. of the German Civil Code, there are two valid forms of wills: the holographic and the public will. The holographic will has to be handwritten, dated and signed by the testator. The public will has to be signed before and certified by a notary public. Neither form of will requires a witness.

A testator can also enter into a contract of succession with another person or 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, Ireland and the United Kingdom. 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, 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: corporations and partnerships**

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 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. 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 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 that 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.

### **iii Trusts**

Neither domestic nor foreign trusts are recognised in Germany. Germany does not have its own trust law. Germany did not ratify the HCCH Convention on the Law applicable to Trusts and on their Recognition 1985. Therefore, German property law does not recognise the transfer of assets located in Germany to a trust. In these circumstances, the terms of a trust are interpreted in accordance with German law for civil law and tax purposes.

Where assets governed by foreign property law have been transferred to an irrevocable trust effectively formed under foreign trust law, the trust can shelter these assets from the settlor's or beneficiary's creditors. German courts generally do not recognise claims against trust assets on the dissolution of a marriage or partnership after 10 years from the date of the transfer.

Foreign trusts are disadvantaged in terms of tax issues when they are established or when distributions to beneficiaries are made (see Section II.iii).

## **V OUTLOOK AND CONCLUSIONS**

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.

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Andreas is the managing director of the Berlin Tax Policy Forum, chairman of the executive board of the postgraduate programme 'Inheritance Law & Business Succession' at the University of Muenster and is a member of the International Academy of Estate and Trust Law. He serves as a member on boards of family offices, foundations and family businesses and acts as executor.

Andreas is the editor of the leading German compendium on foundations and trusts and related tax issues. He also is the author and editor of numerous other publications, commentaries and compendiums, in particular on family offices, foundation law, business succession and all tax-related matters.

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