

25 April 2022

Taxation of Trusts in Germany: New Guidelines for Transparency and the Gift Taxation of Distributions

Recent decisions by the German Federal Fiscal Court (BFH) on matters of Inheritance and Gift Tax (IGT) with regard to foreign trusts resolved some previous ambiguities about the Gift Tax treatment of trusts in Germany. Taxpayers now benefit from more certainty for residency and succession planning. The Court has clarified and confirmed criteria under which a trust qualifies as opaque or transparent for IGT purposes. It declared rules previously developed for foreign foundations applicable to trusts.

Even though German private law does not recognize trusts, German tax law does regulate them to some extent. There are numerous legal questions with regard to the taxation of trusts, ranging from their establishment and distributions by them to their dissolution, which are regulated by both IGT as well as Income Tax law.

SUMMARY

- The establishment of an opaque trust (discretionary trusts are usually considered opaque) by a German tax resident (settlor) or with certain German situs assets triggers Gift Tax. The assets transferred to the trust will not form part of the settlor's estate. However, should the settlor remain able to freely dispose of the trust's assets, the trust may be considered transparent for IGT purposes. In this case, its assets will form part of the settlor's estate and IGT is levied on such assets upon the settlor's death.
- For income tax purposes, distributions made by an opaque trust are treated as capital income (similar to dividends). An additional Gift Tax may only be levied if distributions are made in violation of the provisions of the trust deed or if the recipient is legally entitled in any way to receive the distributed funds (i.e. has a claim to receive distributions as a beneficiary or remainderman). In such cases, trust distributions may trigger both IGT and Income tax.
- Whether a settlor can freely dispose of the trust's assets or whether a beneficiary has a sufficient legal claim to demand distributions is to be determined by the applicable foreign trust law. The burden of proof lies with the taxpayer (e.g. to provide a legal opinion by a foreign legal counsel).

1. Transparency as a Determining Factor

The tax treatment of a trust heavily depends on whether it is tax transparent or opaque.

Transparent trusts are effectively considered non-existent by German Tax Law. Therefore, the trust's assets are attributed to either the settlor or the beneficiaries (depending on the specific circumstances). Consequently, upon their decease IGT is levied on the trust's assets.

Opaque trusts, on the other hand, are treated similar to foreign foundations. This means: The establishment of an opaque trust results in the assets being transferred to the trust, which is then treated as an independent entity for IGT purposes. Establishing an opaque trust triggers IGT if the settlor (or the trust itself) is a German tax resident or the trust receives certain German situs assets to become part of its endowment. In the event of the settlor's death, no IGT is due on the trust assets. The opaque trust is subject to German corporate tax if its place of effective management is located in Germany. If it is tax resident in a foreign country (as usually), beneficiaries with tax residence in Germany may face attributional taxation (CFC/PFIC-rules for trusts). In this case, the trust's assets and income are attributed to them, irrespective whether actual distributions are made. Actual distributions can trigger both Income and Gift Tax. The same applies to the trust's dissolution and subsequent acquirement of its assets.

2. When is a Trust transparent / opaque?

The BFH (decision of 25 June 2021, II R 13/19) has now applied standards previously developed for foreign foundations to the distinction between opaque and transparent trusts. The crucial factor is how much power over the transferred assets still lies with the settlor. Generally speaking, a trust is transparent if the settlor can access its funds or assets it like his/her bank account. This is the case, if (1) the settlor has the right to demand the retransfer of trust's assets to him (revocable trust), (2) the settlor reserves the right to influence or direct decisions about the investment and/or distribution of the trust's assets and (3) the trustees are bound by the settlor's instructions. Whether this is the case depends on the applicable foreign trust law. It is therefore advisable to refer to legal counsel of the respective jurisdiction before the establishment of the trust. In order to convince the German tax authorities of the specific features of the relevant trust, it seems recommendable to provide a legal opinion by foreign counsel. Finally, it should be noted that the Court emphasized that the question of transparency is determined by not only taking into account the legal, but also the factual situation.

3. Gift Tax on Distributions

In another decision (BFH, decision of 25 June 2021, II R 13/19, II R 32/19), the Federal Fiscal Court ruled on distributions by foreign (tax-opaque) trusts to Germany-based beneficiaries. It decided that its previous rulings on foreign foundations shall apply to opaque trusts as well. This means: a distribution from a trust is only deemed a taxable gift, if the receiving beneficiary has rights and claims with regard to the trust's assets and distributions. Whether this is the case depends again on the respective applicable foreign trust law.

The good news for many beneficiaries in Germany therefore is that, generally, distributions carried out by a discretionary trust should not trigger IGT. This is because such beneficiaries (or remaindermen) are usually not entitled to any distributions. In such circumstances, only income tax (26.375% including Solidary Surcharge, excluding church tax) should become chargeable. In other situations, however, where beneficiaries do have certain entitlements, Gift

Tax could be triggered. In these cases, a double taxation with Income Tax and IGT seems to be possible as explicitly stated by the Court.

It is important to note another exception: should a distribution violate the provisions of the trust deed, it would most likely also be taxable under German IGT law as an ordinary gift (BFH, decision of 3 July 2019, II R 6/16 regarding foreign foundations; the principles of this decision should in our view also be applicable to trusts).

4. Possible Double Taxation

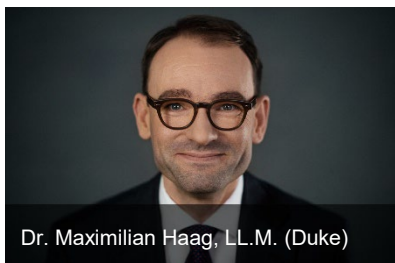
Under some circumstances, a German tax resident may face so called attributional taxation. In this case, the trust's income is attributed to a beneficiary, regardless of any actual distribution. The trust's income is then treated as the beneficiary's personal income and Income Tax is levied, regardless of whether actual distributions were made.

As stated above, actual distributions usually trigger Income Tax as taxable capital income. In such cases, Income Tax previously paid on allocated income can usually be credited. This means, a double taxation with both attributional tax and (subsequently) Income Tax on distributions should – at least in theory – generally be avoided.

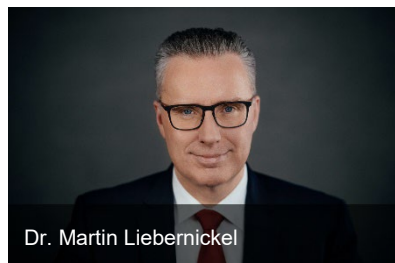
However, a double taxation with both income tax and IGT on actual distributions may occur. The Second Senate of the Federal Fiscal Court explicitly does not consider this as unconstitutional, although the Eighth Senate of the same Court has previously expressed doubts. This question remains unresolved. Therefore, such a situation should be avoided altogether by careful tax planning.

5. Implications

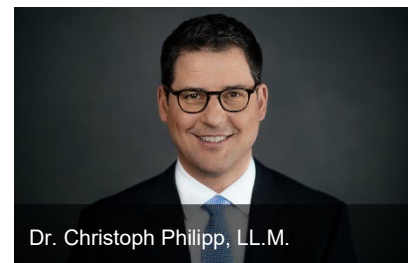
Even though the most recent rulings of the Federal Fiscal Court provide more clarity, some uncertainties remain. The specific interpretation of trust agreements poses a potential risk, as it is not uncommon for settlors or beneficiaries to possess limited rights. The details of every individual case should therefore be evaluated with qualified legal counsel. Ideally, this should take place even before the trust is established (or before the settlor or beneficiary establishes German tax residency) in order to avoid any unnecessary tax risks.



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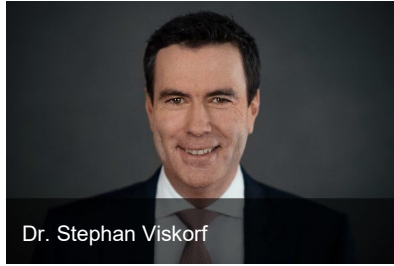
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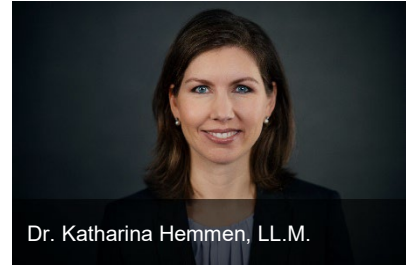
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