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Combining US and German Estate and Gift Tax Planning Tools for the Transatlantic Family

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Dr. Christian von Oertzen/Glenn G. Fox, JD, LLM

Combining US and German Estate and Gift Tax Planning Tools for the Transatlantic Family

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A. US Transfer Tax Planning in a Nutshell*

- Assets Subject to U.S. Estate and Gift Tax

  - Persons who are U.S. citizens, or who are domiciled in the U.S., at the time of death are subject to a 40% U.S. estate tax on their worldwide property and receive a foreign death tax credit for any foreign death taxes paid. Sections 2001 and 2014 of the Internal Revenue Code of 1986, as amended (the "Code").

  - Persons who are U.S. citizens, or who are domiciled in the U.S., are also subject to 40% U.S. gift tax on lifetime gifts they make. Code § 2501(a)(1). There is no U.S. gift tax credit for foreign gift taxes paid unless allowed by treaty.

  - Persons who are neither U.S. citizens nor domiciled in the U.S. at the time of death (also referred to below as a "non-resident/non-citizen" or an "NRNC") are subject to a 40% U.S. estate tax only on "U.S.-situs" tangible and intangible property and real estate, with no credit for foreign death taxes paid, and are subject to a 40% U.S. gift tax on U.S. situs tangible property and real estate. Code § § 2101, 2103, and 2106. (Usually the foreign country will allow a credit against its death taxes for U.S. estate tax paid).

*The slides in this section assume that there is no applicable double tax treaty. Sections D, E, and I below review the impact of the German/US DTT on the U.S. estate tax.

A. US Transfer Tax Planning in a Nutshell

- Generation Skipping Transfer Tax
  - In addition to the estate and gift taxes, assets given during lifetime or bequethed to a beneficiary who is more than one generation below that of the donor or decedent will be subject to an additional 40% generation skipping transfer (GST) tax.
  - Assets left in a trust for the benefit of children and grandchildren will also be subject to the GST tax (in addition to the estate and gift taxes) when assets are distributed from the trust to grandchildren or younger generations or when all of the beneficiaries who are one generation below the grantor (i.e., the children) are deceased.
  - The GST tax only applies if the transfer is also subject to the estate tax or the gift tax. Therefore, a NRNC can create a trust with non-U.S. situs assets for U.S. beneficiaries and the U.S. beneficiaries can benefit from the trust by receiving distributions as they need funds without the trust assets that remain in the trust ever being subject to U.S. estate, gift, or GST tax upon the deaths of the U.S. beneficiaries. This is referred to as a “dynasty trust.”

A. US Transfer Tax Planning in a Nutshell

- "U.S.-situs property" of an NRNC includes:
  - Real property and tangible personal property (including cash, cars, furniture, jewelry, artwork, etc.) situated in the U.S. See Treas. Reg. § § 20.2104-1 and 25.2511-3(b)(4)(iv); Rev. Rul. 55-143, 1955-1 C.B. 465; Blodgett v. Silberman, 277 U.S. 1 (1928); PLR 8138103; and PLR 7737063.
  - Shares of stock issued by a U.S. corporation. Code § 2104.
  - Subject to significant exceptions (set forth below), any debt obligation, the primary obligor of which is a U.S. person or the U.S., a state or any political subdivision of the U.S., or the District of Columbia, or any agency or instrumentality of any such government. Treas. Reg. § 20.2104-1.
  - Property that is gratuitously transferred by an NRNC decedent while alive, by trust or otherwise, which was situated in the U.S. at the time of the transfer or at the time of the decedent's death, if (i) the NRNC decedent retained for life (or for a period that cannot be ascertained without reference to his or her death) some type of possession, control, or enjoyment of said property or its income, (ii) said property was, on the date of the NRNC decedent's death, subject to NRNC decedent's right to alter or revoke the transfer, or (iii) the transferee must survive the NRNC decedent in order to possess the property and the decedent retained a right of reversion in the property.

A. US Transfer Tax Planning in a Nutshell

- "U.S.-situs property" of an NRNC includes (continued from previous slide):
  - An interest in a partnership, if (i) the partnership does not qualify as a separate legal entity under the law of the jurisdiction where it was established or is dissolved on the death of one partner, and the underlying assets of the partnership are situated in the U.S. (see Sanchez v. Bowers, 70 F.2d 715 (2d Cir 1934)) or (ii) the partnership is a separate legal entity under the laws of the jurisdiction where it was established and it survives the death of a partner and the partnership carries out its business in the U.S. (see Rev. Rul. 55-701, 1955-2 C. B. 836 and GCM 18718, 1937-2 C. B. 476).

A. US Transfer Tax Planning in a Nutshell

- Non U.S. Situs Property of an NRNC includes:
  - Shares of stock issued by a foreign corporation. Code § 2104 and Treas. Reg. § 20.2105-1(f).
  - Deposits with persons carrying on the banking business, deposits or withdrawable accounts with a federal or state chartered savings institution (if the interest on such accounts is withdrawable on demand subject only to customary notice requirements), and amounts held by an insurance company under an agreement to pay interest thereon, as long as, in each case, the interest on such deposits or amounts is not effectively connected with the conduct of a trade or business in the U.S. by the recipient thereof. Code § 2105(b) and Treas. Reg. § 20.2105-1(h) and (i).
  - Deposits with a foreign branch of a domestic corporation or partnership engaged in the commercial banking business. Treas. Reg. § 20.2105-1(j).
  - "Portfolio Debt Obligations", as long as the decedent was an NRNC for income tax purposes. Portfolio Debt Obligations are bonds, debentures, notes or other forms of debt which meet specific requirements, such as non-registered obligations available only to non U.S. persons or registered obligations if the payor is advised that the owner is not a U.S. person. Code § 2105(b).
  - Proceeds from a life insurance policy on the NRNC decedent's life. Code § 2105(a).

A. US Transfer Tax Planning in a Nutshell

- Gift Tax Intangibles Exception:
  - NRNC's are subject to U.S. estate tax on all of their worldwide property, whether it is tangible property or intangible property.
  - NRNC's are subject to U.S. gift tax only on lifetime gifts of U.S.-situs tangible personal property and U.S. situs real property, but not gifts of U.S. situs intangible property. See Code § § 2501(a)(1) and (2) and 2511(a). This is referred to as the "intangibles exception."
  - The intangibles exception to the gift tax is not available to certain former U.S. citizens and certain former long-term green card holders. See Code § 2501(a)(3).

A. US Transfer Tax Planning in a Nutshell

- Gift Tax Intangibles Exception (continued from previous slide):
  - Property which is not considered intangible property and is therefore subject to U.S. gift tax includes:
    - Real property situated within the U.S. Treas. Reg. § 25.2511-3(a)(1) and (b)(1).
    - Tangible personal property situated within the U.S. at the time of the gift. Treas. Reg. § 25.2511-3(a)(1) and (b).
    - U.S. or foreign currency or cash situated within the U.S. at the time of the gift. Treas. Reg. § 25.2511-3(b)(4)(iv).
- Property which is considered intangible personal property and is therefore not subject to U.S. gift tax:
  - Shares of stock issued by a U.S. or foreign corporation. Code § 2511(b)(1) and Treas. Reg. § 25.2511-3(b)(3).
  - Debt obligations, including a bank deposit, the primary obligor of which is a U.S. person, the U.S., a State, or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government. Code § 2511(b)(2) and Treas. Reg. § 25.2511-3(b)(4).

A. US Transfer Tax Planning in a Nutshell

- Property which is considered intangible personal property and is therefore not subject to U.S. gift tax (continued from previous slide):
  - Interests in U.S. or foreign partnerships (although there is some debate on whether such interests are intangible personal property). For authorities and commentaries that support this proposition see Blodgett v. Silberman, 277 U.S. 1, 11 (1928), PLR 7737063 (6/17/1977); 2 Rhoades and Langer, U.S. International Taxation and Tax Treaties, § 33.01[2][iii] (1998); Stafford Smiley, Dispositions of U.S. Partnership Interests by Nonresident Aliens, Business Entities, Summer 1991; Robert F. Hudson, Jr., The Tax Effects of Choice of Entities for Foreign Investment in U.S. Real Estate and U.S. Businesses, Business Entities, March/April 2002. For authority that take a contrary position see Rev. Proc. 2004-7, 4.01(25), 2004-1 I. R. B. 237.

- ***Gift Tax Planning Opportunity***: Since the estate taxation of persons who are NRNCs is based on the situs of their assets, regardless of whether the assets are tangible or intangible, while the gift taxation of such persons is based upon whether the assets that they are giving away are tangible personal property or real property situated in the U.S., by taking advantage of the intangibles exception to the gift tax, such persons can give away property which would be subject to U.S. estate tax (such as shares of stock in a U.S. corporation or an interest in a partnership that holds U.S. situs assets), without incurring any U.S. transfer tax and if contributed to a trust, the assets will remain exempt from estate, gift, and GST tax in the estates of any U.S. beneficiaries.

A. US Transfer Tax Planning in a Nutshell

- Estate, Gift, and GST Tax Exemptions
  - As a result of the estate and gift tax unified credit (also referred to as the applicable credit amount) each U.S. citizen and domiciliary has an estate and gift tax exemption which can be applied either against gifts made during life or property owned at the time of death.
  - The exemption for lifetime gifts of U.S. citizens and domiciliaries is $5.25 million, indexed for inflation each year (a total of $10.5 million for a married couple). See Code § 2505(a).
  - For bequests at death for U.S. citizens and domiciliaries the estate exemption is also $5.25 million (a total of $10.5 million for a married couple). If a portion of the gift tax exemption is used during life, the estate tax exemption is reduced by an equal amount. See Code § 2010.
  - Portability – If the first spouse to die does not fully utilize his or her $5.25 million transfer tax exemption, the estate of the first spouse may elect to allow the surviving spouse to use the remainder of the exemption. For example, if the first spouse to die used $3.25 million of his exemption and his estate makes a portability election, the surviving spouse will have a $7.25 million exemption ($5.25 million of her exemption and $2 million from her deceased spouse's exemption). See Code § 2010(c).
  - Each U.S. citizen and resident may also give away up to $5.25 million of assets to people two or more generations younger without imposition of the GST tax (a total of $10.5 million for a married couple).

A. US Transfer Tax Planning in a Nutshell

- Estate and Gift Tax Exemptions (continued from previous slide)
  - The estate tax exemption for bequests at death for NRNCs is only $60,000 (such persons do not receive a lifetime gift tax exemption). See Code § 2107(c)(1).
  - An NRNC who is the surviving spouse of a U.S. citizen or resident cannot utilize the deceased spouse's $5.25 million exemption, since the "portability" provisions only apply to U.S. citizens and residents. See Code § 2010(a) and (c).
- Gift Tax Annual Exclusion - In addition to the estate and gift tax exemption, each taxpayer, whether or not he or she is a U.S. citizen or resident, can give away up to $14,000 (indexed for inflation) a year ($28,000 for a married couple together) to as many people as he or she desires without paying U.S. gift tax or using up any part of his or her estate and gift tax exemption. See Code § 2502(b).

A. US Transfer Tax Planning in a Nutshell

- Estate and Gift Tax Marital Deduction
  - Property passing to a spouse, outright or in certain kinds of trusts, is generally not subject to U.S. estate or gift tax because of the U.S. estate and gift tax "marital deduction." See Code § § 2056(a) and (b) and 2523(a) – (f).
  - However, the estate tax marital deduction is generally not allowed for property passing to a spouse who is not a U.S. citizen, unless the spouse becomes a U.S. citizen before the estate tax return is filed, see Code § 2056(d), or the property that would otherwise pass to the surviving spouse passes, instead, to a "qualified domestic trust" ("QDOT"). See Code § § 2056(d)(2) and 2056A.
  - In addition, the gift tax marital deduction is generally not allowed for property passing to a spouse who is not a U.S. citizen, except that a donor can give his or her non-U.S. citizen spouse up to $143,000 per year (as indexed for inflation for 2011) without the imposition of any gift tax. See Code § 2523(i). A QDOT is not permitted for gifts to a non-citizen spouse.

A. US Transfer Tax Planning in a Nutshell

- Estate and Gift Tax Charitable Deduction
  - Property passing from a U.S. citizen or domiciliary to a U.S. or foreign corporation that is organized exclusively for religious, charitable, scientific, literary or educational purposes, is generally not subject to U.S. estate or gift tax because of the U.S. estate and gift tax "charitable deduction." See Code § § 2055(a)(2) and 2522(a)(2). Compare this to the income tax charitable deduction, which is only available for gifts to U.S. charities. See Code § 170(c)(2).
  - Note that the gift tax charitable deduction is only available to a U.S. citizen or domiciliary with respect to gifts to a foreign charitable organization if substantially substantially all of the contributions to the foreign organization come from non-U.S. donors.
  - In contrast, the estate and gift tax charitable deductions are only available for property passing from a person who is not a U.S. citizen or domiciliary if the recipient charity is a U.S. corporation. See Code § § 2106(a)(2)(A)(ii) and 2522(b)(2).

A. US Transfer Tax Planning in a Nutshell

- Other Estate Tax Deductions for NRNCs
  - Estates of NRNCs are entitled to deduct from the gross value of the estate a portion of the expenses, losses, indebtedness, and taxes of the estate under Code § § 2053 and 2054, which include funeral and administration expenses, claims against the estate, mortgages on, and indebtedness with respect to, property included in gross estate, and uninsured casualty losses suffered by the estate. See Code § 2106.
  - The portion of aforementioned expenses which the estate of an NRNC may deduct is determined under Code § 2106 and Treas. Reg. § 20.2106-2(a)(2) by a fraction, the numerator of which is the value of gross estate situated in the U.S., and the denominator of which is the value of all property, wherever situated, included in the gross estate. In contrast, the estate of a U.S. citizen or domiciliary may deduct 100% of such expenses from the value of the estate.
  - Consequently, a note secured by a mortgage on U.S.-situs property is only partially deductible, notwithstanding the fact that the mortgaged property is includible in full for estate tax purposes. If, instead, the property is subject to a mortgage as to which the mortgagor has no personal liability, only the value of the property less the mortgage or indebtedness is included in the gross estate, thus giving a 100% deduction of the mortgage. See Treas. Reg. § 20.2053-7.

A. US Transfer Tax Planning in a Nutshell

- Domicile Issues
  - For purposes of the U.S. estate and gift taxes, an non-U.S. citizen is considered a U.S. resident for if he or she is domiciled in the U.S. at the time of his or her death or at the time of a gift.
  - If a non-U.S. citizen enters the U.S. for even a brief period of time, with no definite present intention of later leaving the U.S., he or she is deemed to be domiciled in the U.S. and, therefore, is considered a U.S. resident for estate and gift tax purposes. See Treas. Reg. § § 20.0-1(b) and 25.2501-1(b).
  - Under the U.S. tax regulations, a person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom.
  - A non-U.S. citizen may be considered an NRNC for estate tax purposes and a U.S. resident for income tax purposes, or vice versa, since the estate tax residency test is the more subjective domicile test just described, while the income tax residency test is met if the alien satisfies an objective day count test known as the “substantial presence test” or holds a green card.

A. US Transfer Tax Planning in a Nutshell

- Domicile Issues (continued from previous slide)
  - The determination of domicile for estate and gift tax purposes is a factual issue that focuses on the following factors (No one factor is determinative of whether a non-U.S. citizen is domiciled in the U.S. for estate tax purposes. In each case all of the facts and circumstances are examined.):
    - The length of time spent in the U.S. and abroad and the amount of travel to and from the U.S. and between other countries. See Paquette Est. v. Comr., T.C. Memo. 1983-571.
    - The value and size of the donor's or decedent's homes and whether he or she owned or rented them. See Fokker Est. v. Commr., 10 T.C. 1225 (1948). If the home owned abroad is worth substantially more than the home owned in the U.S., this could be an indication that the alien was not domiciled in the U.S. If the non-U.S. citizen owned a home abroad and only rented a residence in the U.S., this could also be an indication that he or she was not domiciled in the U.S. Nevertheless, under certain circumstances renting a residence in the U.S. may also indicate intent to stay.
    - The locations of houses and other residences, since a house in a vacation area is less of an indication to remain indefinitely than in other areas. See Nienhuys Est. V. Comr., 17 T.C. 1149 (1952).
    - The situs of valuable or meaningful tangible personal property. See Farmers' Loan & Trust Co. v. U.S., 60 F.2d 618 (S.D.N.Y. 1932).

A. US Transfer Tax Planning in a Nutshell

- Where the non-U.S. citizen's close friends and family are situated. See Nienhuys.
- The locales in which the non-U.S. citizen has religious and social affiliations or in which he or she partakes in civic affairs. See Farmers' Loan and Nienhuys.
- The locales in which the non-U.S. citizen's business interests are situated. See Fokker.
- Visa status.
- The places where the non-U.S. citizen states that he or she resides in legal documents, such as deeds, wills, trusts, letters, etc, or in verbal communications. See Fokker and Farmers' Loan.
- Whether the non-U.S. citizen spends time in a locale due to poor health, for pleasure, to avoid political problems in another country, etc. See Nienhuys and Fokker.
- The jurisdiction where the non-U.S. citizen is registered to vote.
- The jurisdiction that issued the non-U.S. citizen's driver's license.
- Income tax filing status (although income tax filing status or residency status does not necessarily determine that a non-U.S. citizen is a resident for estate and gift tax purposes, the chances are significantly greater that a non-U.S. citizen will be considered a U.S. resident for estate tax purposes if he or she is a U.S. resident for income tax purposes and particularly he or she has a permanent resident visa (i.e., a "green card").

B. German Transfer Tax Planning in a Nutshell

- Inheritance, **not estate tax**.
- **Same principles** for inheritance and **gift tax**. **No generation skipping tax**.
- **Substantial personal tax allowances** granted **every 10 years** for spouses (EUR 500.000), children (EUR 400.000 per child) and grandchildren (EUR 200.000 per grandchild).
- **Tax exempt transfer** of the **family home** situated in Germany/EU/EEA by the owner to the spouse intervivos or postmortem (then with a clawback clause) possible. A postmortem transfer of the family home to children is also possible but must fulfill also a special clawback system.
- **Special marital allowance** in case that the spouses are living under the German *Zugewinngemeinschaft*: An amount as high as the actual accrued surplus during marriage can be transferred to the spouse tax free.

B. German Transfer Tax Planning in a Nutshell

- Example:

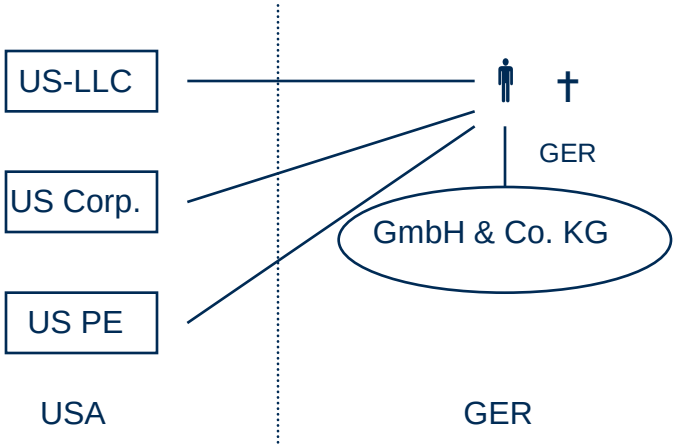
  Man and woman marry with, both having no assets at the beginning of the marriage. When the husband dies or if the spouses get divorced or enter into separation of property, the assets of the husband have a value of EUR 10 millions, the assets of the wife have a value of EUR 1 millions. In case of divorce the husband would have to pay EUR 10 – 1 / 2 = EUR 4.5 millions as Zugewinnausgleich.

  In case of death an amount of EUR 4.5 millions inherited by the wife is exempted from inh. tax.

- **A special tax relief system** is provided for with respect to **business assets**, agricultural and forest property and capital interest in **corporations** in **Germany/EU/EEA**. This tax system can give a 85 % or 100 % tax relief. This tax relief system can be also used in US/German estate planning situations.

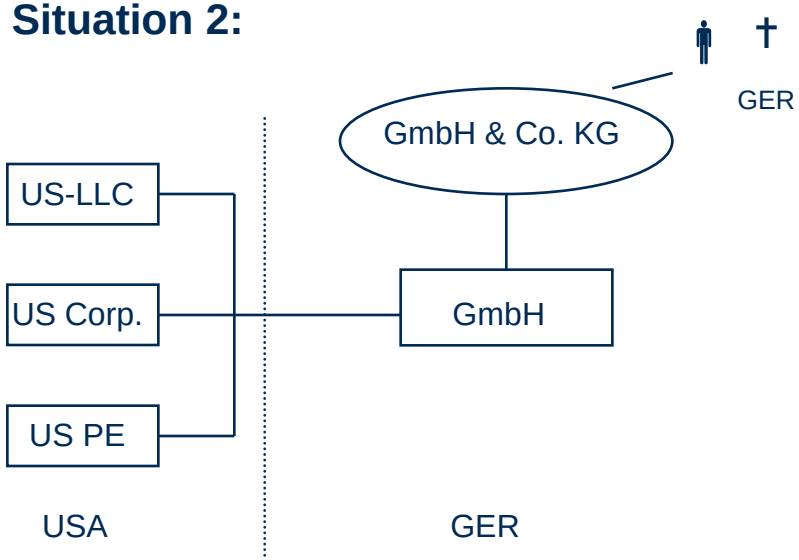
B. German Transfer Tax Planning in a Nutshell

Situation 1:



→ **No discounts** available under Sec. 13a, 13b German IHT

Situation 2:



→ **85 % or 100 % discount available** under Sec. 13a, 13b German IHT if the other pre-conditions are fulfilled. The territorial limitations do not apply anymore.

→ **See also H.E 13b.5 ErbStH:** works also in a double (?) partnership structure

B. German Transfer Tax Planning in a Nutshell

- **Tax planning** with **tax valuations methods** used in the past has become very difficult. Our new transfer tax system is based on the system of fair market value for all assets. Nevertheless, in some areas limited possibilities remain (e.g. concerning real estate, *Vergleichswertverfahren* vs. *Ertragswertverfahren*).

- Transferring assets and **retaining a life interest right/usufruct right** is becoming more **important** because under our new laws the retained right can be deducted from the value of the assets and - different from the US - this gift qualifies as a **completed gift**.

- **Unlimited tax liability** is levied on the *Wohnsitz* or *gewöhnlicher Aufenthaltsort* of the testator (donor) **and**/or the **heir/donee**.

- **Germany** does **not know trusts** in our civil law system, especially testamentary trusts and in case of the application of German laws of succession **does not accept them**.

- **Germany** does **not accept trusts** owning **German assets** (see *BGH*, IPrax 1985, 221; *LG München*, IPrax 2001, 459).

B. German Transfer Tax Planning in a Nutshell

- The **creation** or funding of a "*Vermögensmasse ausländischen Rechts, deren Zweck auf die Bindung von Vermögen gerichtet ist*" (**the creation or funding to a pool of assets governed by foreign laws which has its purpose in the segregation of property**) is a gift or inheritance in **tax bracket III** in case Germany has the right to tax.
- **Every distribution** from this entity to the German beneficiary is a **gift** between the settlor and the beneficiary with the result that their relationship decides with respect to the applicable tax bracket and tax allowance in case Germany has the right to tax.
- The **cessation** of such an entity is a **gift** by the settlor to the remaindermen.

B. German Transfer Tax Planning in a Nutshell

- The German revenue service has not issued any revenue ruling on the interpretation of these tax rules until now (nevertheless, we obtained favourable private letter rulings in connection with US and Jersey trusts).
- **Qualification of trust types:**
  - A dynasty trust set up for **US generation skipping tax purposes** is such an entity.
  - A **Bahamas STAR-trust** without a rule against perpetuities is such an entity.
  - A **revocable inter vivos** trust should not be such an entity. A taxable event would occur if such an inter vivos revocable trust becomes irrevocable.
  - A trust created under the **US UTMA-Acts** is not such an entity.
  - Fiscal Court of Baden-Württemberg (decision of July 15, 2010), Federal Fiscal Court (decision of September 27, 2012): *"A US grantor trust does not qualify"*.

B. German Transfer Tax Planning in a Nutshell

- An irrevocable inter vivos trust may qualify:
  - (i) Especially in case it is a discretionary trust.
  - (ii) Questionable in case it is a strict trust or fixed interest trust.
- Federal Fiscal Court (decision of September 27, 2012): "*The provisions shall also apply in case a claim is granted to the beneficiary*".
- Argueable: A trust with the only purpose to avoid probate and without dynastic function, just distributing the assets and clearing the debts (e.g. to avoid expensive California probate) should not qualify.

■ No back up inheritance tax for foreign trusts owning (indirectly) German assets.

B. German Transfer Tax Planning in a Nutshell

	creation	during the existence	liquidation
Tax object	• creation • funding	• distribution to „Zwischenberechtigte“ • income and corpus	distribution of the assets to the remaindermen
Taxpayer	• trustee or • settlor	• „Zwischenberechtigte“ or • Trustee	• remaindermen or • trustee
Tax bracket	III (from 30 % to 50 %)	relationship between settlor and beneficiary decisive	relationship between settlor and beneficiary decisive

C. Conclusions for the Combined Planning

- A strategy combining the German personal tax allowances and the annual US Gift Tax Allowances is possible.

- German usufruct/life interest right strategies are difficult to accomplish in case the US has also the right of taxation.

- Trusts can only be very seldomly used in US/German estate planning cases.

- The US lifetime USD 5.25 million gift exclusion amount per spouse (a total of USD 10.5 million) should be used combined with the German personal allowances.

  - Use the US USD 5.25 million gift tax exclusion amount to make discounted gifts of closely held business interests. Discounts are permitted if interests are not freely marketable and if interest is a minority interest due to lack of control. With a discount of 30%, interests worth USD 15 million can be given away by using the combined USD 10.5 million exclusions of the spouses.

  - Fund a family limited partnership with marketable securities and give away minority interests in the partnership to family members using the exclusion amount, combined with discounting, and discount the remainder that is retained by the donor at the time of his death (the donor should not remain the general partner of the partnership or he or she will risk inclusion of all of the partnership assets in his or her estate).

C. Conclusions for the Combined Planning

- Life Insurance for US Estate Tax Planning
  - Consider purchasing life insurance to help fund the US estate tax.
  - Life insurance owned by an NRNC decedent is not subject to the US estate tax, as explained above, so it is a useful tool when an NRNC has significant US assets, like US real estate, partnership interests, or business property. The NRNC can own the insurance and his heirs can use the proceeds to pay the US estate tax.
  - Life insurance owned by a citizen or resident of the US is subject to the US estate tax. Therefore, if the insurance is intended to be used to pay estate tax, it should be owned by the insured's intended heirs, an irrevocable trust for the benefit of the heirs if they are minors, or a partnership in which the minor heirs are limited partners and the other parent (or a third party) is the general partner. The trust or partnership can loan funds to the estate or purchase assets from the estate in order to help fund the estate tax.
  - Gifts to the heirs, the trust, or the partnership equal to the US 5.25 million lifetime exclusion amount (US 10.5 million for a married couple) or the annual $14,000 exclusion amount per donee (a total of $28,000 per donee for gifts from a married couple) can be used to fund the insurance premiums.

C. Conclusions for the Combined Planning

- Grantor Retained Annuity Trust for US Estate and Gift Tax Planning
  - Consider using a Grantor Retained Annuity Trust ("GRAT") to transfer the appreciation of interests in closely held businesses or marketable securities. With a GRAT, donor retains an annuity stream for a term of years and the appreciation of the interest after the term of years passes the remaindermen of the trust without any gift taxes.
  - Since Germany does not recognize trusts, this technique is better suited for a US citizen or resident who owns US or German private or public companies. If the company is a German company, the shares in the company should be transferred to a US limited liability company so that ownership from the German perspective is not through a trust. The shares in the US limited liability company are then transferred to the Grantor Retained Annuity Trust.

D. Overview on the US/German Estate and Gift Tax Treaty (DTT)

Right to tax U.S.A. / Germany						
Resi-dence of decedent	**Nationa-lity 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	ire-levant	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

D. Overview on the US/German Estate and Gift Tax Treaty (DTT)

- Domicile under the DTT – A person is deemed to be domiciled in the US if he or she is a resident or citizen of the US, and he or she is deemed to be domiciled in Germany if he has his domicile or habitual abode in Germany, or if he is deemed for other reasons to be subject to unlimited tax liability for the purposes of the German inheritance and gift tax. If the individual is deemed to be domiciled in both countries under the above rules, "tie-breaker" provisions will apply. Notwithstanding the general tie-breaker rules, if an individual, at the time of his or her death or at the time of making a gift was a citizen of Germany and not a citizen of the US (or vice versa) and, under the respective laws of each jurisdiction, is deemed to be domiciled in both countries, but the individual has not been domiciled in the US (or vice versa) for more than 10 years, he or she will be deemed to be domiciled in Germany for purposes of the treaty. After 10 years, the traditional tie-breaker rules apply. Article 4.

- Property subject to estate and gift tax under the DTT – Real property and business property situated in the US and owned by a German NRA (or vice versa) and an interest owned by a German NRNC in a partnership that owns such property may be subjected to US estate and gift tax. Any other property of a German NRNC, including cash, tangible personal property, and debt obligations situated in the US and shares of stock in US corporations may only be taxed by Germany. Articles 5, 6, and 7.

D. Overview on the US/German Estate and Gift Tax Treaty (DTT)

- General Deductions – The DTT allows for direct deductions of certain debts incurred for the purpose of the acquisition, repair, operation, or upkeep of property that is subject to taxation under the DTT. Article 10(1).

E. The Ten-Year-Rule of Art. 4 Para. 3 DTT

A US citizen coming **from the US to Germany** is protected against German estate taxation on his worldwide estate during the first ten 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 living less than ten years in Germany in the same household with the testator and no German real estate or business assets are transferred to him.

→ **Trust strategies for liquid assets in the first ten years after coming to Germany work! (But must qualify for US and German tax purposes as a US or foreign trust!)**

E. The Ten-Year-Rule of Art. 4 Para. 3 DTT

- A **German citizen** coming **from Germany to the US** is protected against US estate taxation on his worldwide estate during the first ten years in the US, if

  (i) the beneficiary/heir is domiciled in Germany and no US real estate or US business assets are transferred to him, or

  (ii) the beneficiary/heir is a German citizen living less than ten years in the US in the same household with the testator and no US real estate or business assets are transferred to him.

  → **The ten year rule does not apply to dual citizens and family members who live in the same household but do not have the same citizenship.**

E. The Ten-Year-Rule of Art. 4 Para. 3 DTT

- **Case:**

  Testator Hans, German citizen, investment banker, was sent in 2005 to the New York branch of Deutsche Bank. He was married to Gisela and had 2 children, all German citizens. In 2007 he received a green card. He planned to stay in the US. He is passing away in 2013. He is leaving liquid assets in New York and Frankfurt, real estate in Bad Homburg, IRA pension accounts and life insurance contracts to his family.

E. The Ten-Year-Rule of Art. 4 Para. 3 DTT

I. German Taxation

- He is still unlimited tax liable under the DTT in Germany although under US laws he maybe already treated as being a domiciliary for US tax purposes.

- The 10 year rule also applies in case when the deceased did not directly come from Germany to the US but via a third country. The 10 years start to run with the expatriation from Germany, not with the immigration into the US.

II. US Taxation

- Because Hans intended to remain in the US, had a green card, and his family was in the US, it is very likely that the US will deem him to be domiciled in the US for US estate tax purposes at the time of his death.

- Notwithstanding his status as a US domiciliary under general US estate tax principals, since he was not domiciled in the US for more than 10 years, under the DTT he will be deemed to be domiciled in Germany, the country of which he was a citizen. Therefore, only US real property that he may have owned and business interests will be subject to US estate tax. Since he owned no such interests, no US estate tax will be due.

E. The Ten-Year-Rule of Art. 4 Para. 3 DTT

- **Application of Art. 4 Para. 3 also to Incoming US Heirs or Donees?**

- **Case:**

  The US citizen, Tom Goldman, came to Berlin for working purposes in 2010 in the Babelsberg Filmindustries. He likes Germany, nevertheless, he is convinced that one day he will return to the US. In 2013 his mother passes away and he inherits a share in her estate in the value of USD 10.25 million.

I. US Taxation

- The US estate tax is imposed upon the estate as a separate entity. Therefore, the estate, not the heir pays the estate tax.

- Assuming that his mother did not utilize any portion of USD 5.25 million gift tax exclusion while she was alive and that the estate tax exclusion is USD 5.25 million when she dies in 2013 her estate will pay a USD 2,000,000 estate tax (assuming a 40% estate tax rate) and he will net USD 8,250,000.

E. The Ten-Year-Rule of Art. 4 Para. 3 DTT

II. German Taxation

- Treaty protection?

- From the wording of Art. 4 Para. 3 DTT the 10 year rule does not apply.

- But under Art. 11 Para. 1 DTT Germany is only entitled to tax heirs if they have a domicile ("*Wohnsitz*") not only under domestic laws in Germany but also in the meaning of the treaty. Art. 11 DTT refers to Art. 4 in its entirety.

- For interpretation of the term "*Wohnsitz*" in the meaning of the treaty see *Debatin/Wassermeyer/Hundt*, DBA, Art. 11 DBA-USA (e), note 15; *Becker/Höppner/Grotherr/Kroppen*, DBA Kommentar, Art. 11 DBA-USA (e), note 4; *Köhler*, DBA, Art. 11 DBA-USA (e), note 11. → **Art. 4 Para. 3 DTT should also apply to the incoming heir**.

- **But:** The prevailing view in literature was doubted in an informal discussion with the Revenue Service just recently!

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

- **Case:**

  The Hamburg based German citizen Hans was invested in the following US entities:

  (i) US corporation

  (ii) US limited partnership

  (iii) US LLC, which is treated as a partnership for income tax purposes in the US

  His two sons are heirs of his estate. They are both living in Germany and they are both German citizens.

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

Right of Taxation in the US and Germany under the treaty

I. US Taxation

- US corporation: Art. 9 DTT: Only Germany has the right of taxation.

- US limited partnership and LLC treated as a partnership for tax purposes:

  - Under Art. 8 of the DTT the US has the right to subject the NRNC's interests in these two entities to estate tax if the they hold US real property or business interests of a permanent establishment in the US. The US will subject a partnership interest to the US estate tax if (i) the partnership does not qualify as a separate legal entity under the law of the jurisdiction where it was established or is dissolved on the death of one partner, and the underlying assets of the partnership are situated in the US or (ii) if the partnership is a separate legal entity under the laws of the jurisdiction where it was established and it survives the death of a partner and the partnership carries out its business in the US It is likely that one of these rules will apply in this case and that the partnership and LLC will therefore be subject to US estate tax.

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

- For US tax purposes, a business entity with two or more members is classified as a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded for tax purposes. If the entity is disregarded, its activities are treated as if the entity was a sole proprietorship.
- Generally speaking, a US entity will be treated as a corporation if it is organized under a Federal or State statute that refers to the entity as incorporated or as a corporation.
- Generally speaking, a foreign business entity will be classified as a corporation if it is on the list of foreign organizations, a so-called "per se" entity, which are deemed to be corporations. The *Aktiengesellschaft* (AG) in Germany is a per se corporation. An entity with at least two members that is not deemed to be a corporation under these rules is treated as a partnership for US tax purposes. See Treas. Reg. § 301.7701-2(a), (b), and (c).

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

- Under the so-called "check the box rules" of Treas. Reg. § 301.7701-3, a business entity that is not classified as a corporation (an "eligible entity") can elect its classification for federal tax purposes. An eligible entity with at least two members can elect to be classified as a corporation or a partnership, and such an entity with a single member can elect to be classified as a corporation or to be disregarded as an entity separate from its owner. Treas. Reg. § 301.7701-3(a).
- A US eligible entity that does not make an election is deemed to be a partnership if it has two or more members or a disregarded entity if it has a single owner.
- A non-US eligible entity that does not make an election as to its treatment will be treated as a corporation if all its members have limited liability and will be disregarded as an entity separate from its owner if it has a single owner that does not have limited liability, and it will be treated as a partnership if it has two or more members and at least one member does not have limited liability. Treas. Reg. § 301.7701-3(b).

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

→ In the above example, it is assumed that the US LLC has two or more members and, for this reason it has defaulted to a partnership. *Hans* and his partners could have made a check the box election for the LLC to be taxed as a corporation, and *Hans'* interest in the partnership would have be sheltered from US estate tax under the DTT. However, such an election would have resulted in double taxation of the entity's income (once when the income is received by the entity and again when the net income is distributed as dividends). If the owners of the entity choose to go with the default classification as a partnership to avoid double income taxation, one planning technique to avoid estate tax, would be for *Hans* to make gifts of the LLC interests prior to his death, which should be exempt from the US gift tax under the intangibles exception discussed above, and to acquire life insurance to pay the tax if he dies before giving away all of the interests.

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

II. German Taxation

- US corporation: Art. 9 DTT: Only Germany has the right of taxation.

- US limited partnership:

Germany accepts the US taxation under Art. 8 and 6 DTT. Germany would credit the US taxes.

- US LLC:

If the LLC qualifies under the German Revenue Decree (BMF IV B 4-S1301 USA-22/04 of 19th of March 2004, BStBl. 2004, I, 411) as a partnership branch Germany would allow a US tax credit against the German inheritance taxes.

In case it qualifies for German income tax purposes as a corporation, Germany would follow this result also for inheritance tax purposes. Then Germany would not allow a US tax credit.

For planning purposes it should be avoided that for income tax purposes the US entity is treated differently in the US and Germany. Otherwise double taxation in estate matters cannot be avoided.

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

- **Case:**

  The German real estate investor and entrepreneur Peter owns substantial business and residential property in Manhattan. The structure is the following:

  He owns a German GmbH & Co. KG entity that is the holding for his US partnerships. For US income tax purposes, the GmbH & Co. KG is treated as a corporation.

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

I. US Taxation

- The characterization of Peter's company as a corporation for income tax purposes will also be respected for estate tax purposes. Since Peter owns the US partnerships through a corporation, the property will not be subject to estate tax under Art. 9 of the DTT.

- Although Peter's use of a foreign (German) corporation to hold the US partnership interests is beneficial because it shelters the property from US estate tax, this form of ownership has the following negative US income tax implications: (i) the US source income generated by the partnerships will be subject to double taxation; (ii) a foreign corporation engaged in a US trade or business is subject to a 30% branch profits tax on earnings of the US business that are deemed repatriated offshore; and (iii) a foreign corporation that owns US real property and sells that property is subject to FIRPTA withholding and generally subject to branch profits tax.

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

- Ownership US partnerships through a US subsidiary corporation of a foreign corporation that is owned by Peter: This is a better overall structure than direct ownership by Peter through a foreign corporation because this structure avoids gift and estate tax and the branch profits tax. Since the DTT shelter's shares of stock in a US owned by an NRA residing in Germany from the estate tax, Peter could also achieve these benefits by directly owning the interest in the US corporation. Of course, there will still be double taxation if dividends are paid. In addition, the entity may be considered a "personal holding company" ("PHC"). A PHC prevents the avoidance of shareholder level taxes by the accumulation of certain types of earnings by certain closely-held corporations. The PHC rules impose a penalty tax at the corporate level on the "undistributed personal holding company income" of a PHC.

- Peter could own the partnership interests directly, and would avoid the above income tax problems, but the partnership interests would then be subject to estate tax. Again, he could give away the interests without any gift tax due to the intangibles exception and could acquire life insurance to help pay any estate tax.

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

II. German Taxation

- Resident tax: Germany is entitled to tax
- One should consider to structure the KG that its assets qualify under Sec. 13a, 13b German IHT

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

- **Variation:**

  Does Art. 8 allow a look through only in one tier and not in double tier partnership structures?

  - Under Art. 8 of the DTT, a double tier partnership would not protect the underlying US assets from US estate tax if the assets are real property or business property situated in the US.

  - However, applying general U.S. common law principles there is an argument that can be made to exempt an interest in a foreign partnership owned by a NRNC from the U.S. estate tax even if the partnership owns U.S. real property, although this concept is not without risk and is subject to challenge by the U.S. IRS. The argument may be strengthened if a two tier foreign/US partnership is used to own the U.S. real property.

  - See *Hudson, Robert F*, Foreign Investments in the United States, A Practical Approach in the 1990s, New York, 513-526; see also *Bricker, Williams*, 537-765, problematic!

F. Planning Pitfalls and Opportunities with Check-the-Box-entities

- **Case:**

  Testator Fritz, German citizen, lived in Germany and owned substantial property in Germany and invested in a US real estate partnership. He passed away and left the US partnership interest to his son. The value of the real estate in time of acquisition was USD 10 million. The real estate was financed through a loan in the amount of USD 8 million. Due to the financial crises at time of his death the value of the real estate partnership was only USD 5 million. The loan was still open on the amount of USD 4 million. The overall estate of Fritz was USD 70 million.

G. Deduction of Debts under the Treaty

I. US Taxation

- Since the partnership holds US real property and carries out its business in the US, the partnership interest will be subject to US estate tax upon Fritz's under Art. 8 of the DTT.

- However, under Art. 10(1) of the DTT, Fritz's estate will be permitted to deduct the USD 4 million debt. Since the interest has a value of USD 5 million, only USD 1 million will be subject to US estate tax, which will be approximately USD 400,000 at a 40% U.S. estate tax rate.

II. German Taxation

- Germany is entitled to tax Fritz's worldwide estate.

- The right of taxation is not limited by the treaty.

- All debts can be deducted in Germany without any limitations, Germany will credit US taxes on US real estate/US partnership assets-

  (see *Wassermeyer*, in: Debatin/Wassermeyer, ErbSt-DBA-USA, Art. 10, note 11; *Bellstedt/Worm/Bödecker*, ErbStB, DBA-USA, Art. 10, note 3 ff.).

G. Deduction of Debts under the Treaty

- **Variation:**

  The deceased owned a term insurance issued by an US carrier to refinance the loan. Beneficiary was the German heir. With the proceeds of the term insurance the German heir is repaying the loan.

  I. US Taxation

  - The insurance will not be subject to US estate tax in the estate of an NRA under general US estate tax principals and the loan will be deductible under the DTT.

  II. German Taxation

  - The proceeds of the term insurance are inheritance taxable in Germany.
  - As a term insurance, the proceeds are not taxable income for the German heir. Even in case the insurance has a cash value, there would be no German income taxation.
  - Planning should be undertaken for avoiding the German inheritance taxes on the life insurance proceeds.

H. Providing for the Surviving Spouse: The Treaty Benefits

Deceased

US citizen

German citizen

***Wohnsitz* („domicile") in the US (Reg. § 20.0-1(b)(1)**

***Wohnsitz* („domicile") in Germany**

Estate unlimited tax liable

•Estate is limited tax liable in the US

worldwide taxation

Heir is not the surviving spouse

$5.25M Unified Credit („applicable exclusion amount", Sec. 2010 (a) IRC)

Heir is the surviving spouse and

German citizen

1. Limited spousal exem-ption („applicable exclusion amount") of $5.25M, Art. 10 Para. 6 DTT)
2. $5.25M Unified Credit („applicable credit amount", Sec. 2010 (a) IRC)

US citizen

Unlimited spousal exemption (Sec. 2056 IRC)

Heir is the surviving spouse and

German citizen

1. 50% Discount (Art. 10 Para. 4 DTT)
2. Limited spousal exemption („applicable exclusion amount", Art. 10 Para. 6 DTT)
3. Fraction of $5.25M Unified Credit („applicable credit amount") in the ratio of US gross estate to entire gross estate wherever situated, minimum USD 60,000 (Art. 10 Para. 5 DTT)

Heir is not the surviving spouse

Fraction of $5.25M Unified Credit („applicable credit amount") in the ratio of US gross estate to entire gross estate wherever situated, minimum USD 60,000 (Art. 10 Para. 5 DTT)

H. Providing for the Surviving Spouse: The Treaty Benefits

- **Case:**

  Herman, the decedent, and Wilhemina, his surviving spouse, are German citizens and residents. Herman dies in 2013 when the US estate tax exemption is USD $5.25 million. Herman owned US real property in Naples, Florida worth USD 12 million at the time of his death, all of which he bequeathed to Wilhemina. The remainder of his estate consists of USD 40 million of German property.

H. Providing for the Surviving Spouse: The Treaty Benefits

What is the US estate tax liability for Herman's estate?

- Under Art. 10(4) of the DTT, only 50% of the total value of the US real property bequeathed to Wilhemina is subject to US estate tax, so only USD 6,000,000 of the USD 12 million Naples property is subject to US estate tax.

- In addition, under Art. 10(6) of the DTT, the value of Herman's taxable estate is determined by deducting an amount equal to the value of any interest that passes to Wilhemina, up to USD $5.25 million in value (the amount equal to the US estate tax exclusion amount), provided that at the time of Herman's death, Herman was domiciled in Germany or the US. Wilhemina was domiciled in Germany of the US, and Herman's executor elects to waive the benefits of any other estate tax marital deduction under US law (like a QDOT). Assuming that all of these criteria are satisfied, only USD 750,000 of the USD 6,000,000 tax base will be subject to US estate tax.

- Art. 10(5) would also entitle Herman's estate to a pro-rata portion of the USD $5.25 million estate tax exclusion based on the ratio of his US estate, USD 12 million, to his worldwide estate, USD 52 million. 12/52 x USD 5.25 million = USD 1,211,538. Therefore, the remaining USD 750,000 that is subject to US estate tax is sheltered from tax by the USD 1,211,538 exemption under the DTT.

H. Providing for the Surviving Spouse: The Treaty Benefits

- **Case:**

  Mr. and Mrs. Moser are German citizens domiciled in Dusseldorf/Germany. Mr. Moser passed away in 2013 owning German real estate (EUR 4 million), US stocks and US bonds (USD 3 million) and a Florida vacation home, acquired for EUR 6 million in 2006, valued in 2013 at USD 4 million. Mrs. Moser inherits all of the US real estate and one half of the balance of the remaining properties divided between her and the children pursuant to German law.

  What is the US tax liability for Mr. Moser's estate?

H. Providing for the Surviving Spouse: The Treaty Benefits

- Pursuant to the US/German DTT, only the US real estate is subject to US estate tax. The USD 4 million of the real estate qualifies for the US estate tax marital deduction in the year 2013 under the DTT (because the applicable exclusion amount is USD 5.25 million). Therefore, again, the estate carries no US Estate Tax Liability.

⇨ **Often a German family owning vacation homes or other form of real estate in the US do not have a US estate tax exposure when the real estate is passing to the surviving spouse.**

- **Planning note:** Nevertheless, also in these cases a civil law planning is necessary.

H. Providing for the Surviving Spouse: The Treaty Benefits

- **Consequences for a planning under the DTT:**

  - In case of “smaller” US real estate investments the real estate investments should go to the surviving spouse **making use** of the **exemptions granted under Art. 10 Para. 4 to 6 DTT**. QDOT is often not necessary or the option to take on the US citizenship.

  - In case the investments exceed the exclusion amounts granted under the DTT, consider

    (i) the **intangible property exemption** under US laws,

    (ii) **life insurance planning,**

    (iii) **debt financing,**

    (iv) more sophisticated planning with **partnerships** and **corporations** with the US check-the-box regulations.

I. Trusts and the DTT

- **Art. 12 Para. 3 DTT:**

  In a case the transfer of a property to an estate or trust does not result in a taxable transfer at such time under the German Inheritance and Gift Tax, the beneficiary of the estate or 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.

  → Important planning options for individuals residing in Germany (e.g. German citizens residing in Germany/US citizens longer than ten years in Germany).

- **Consequences of the election**:

  (i) **Prevailing view in German literature:** Applicable in case Germany did not have the right to tax in the moment of creation of the trust (US domiciliary is transferring non German assets to a US (non German) trust).

  (ii) The German beneficiary is treated as if he had acquired all the trust assets at the moment of death from the settlor.

  (iii) He can credit all US Transfer Taxes triggered at the date of death against the German Inheritance Taxes.

I. Trusts and the DTT

- Unclear are the consequences of the election right in case the German beneficiary makes use of the election right but the trust itself is not terminated.
- **Case:**

  A US citizen and domiciliary creates under his last will and testament inter alia for the benefit of his German grandchild an irrevocable testamentary generation skipping trust in the year 2009. The grandchild opts for the taxation under Art. 12 Para. 3 DTT. In the following years the yearly income is distributed to the German grandchild.

  Question: Are the payments from the trustee to the German grandchild gift taxable in the meaning of Para. 7 Para. 1 no. 9 German IGTA?

I. Trusts and the DTT

- ***Habammer*:**

  With the election the termination of the trust in the moment of the creation of the trust is deemed for tax purposes. The later termination of the trust is therefore not anymore a transfer tax event. Nevertheless, in the meantime a distribution of the trust to the grandchild remains gift taxable. The option "*wirkt nicht zeitraumbezogen, aber zeitpunktbezogen*".

- ***Jülicher*:**

  Result of the election is, that for inheritance tax (and income tax) purposes there is no trust anymore. The beneficiary must be treated as if he is already the owner of the assets.

- Caution should be taken when making use of the election right in case it is planned that the trust asset should not be distributed to the German beneficiary.

- Unclear is the situation how the beneficiary would be treated in case he passes away.

  - Thinkable approach of the German Revenue Service:

    He is 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.

I. Trusts and the DTT

- **Christian's** approach:

  This should not be the case. Only a fictitious ownership ends but there is no transfer of legal ownership. Under German gift and inheritance tax principles only a "real" 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.

- Concerning income tax consequences see J.

- Go for a private letter ruling before making use of the election right of Art. 12 Sec. 3 DTT.

J. Trusts and Income Taxes

- A US trust can be qualified as
  - a fiscal transparent conduit (fiduciary arrangement)
  - a separate legal entity that is treated as a corporate tax payer
  - as a family trust that is subject to the special tax regime for undistributed income under the German FTA-rules.
- Fiduciary agreement:

  Often:
  - Grantor Trusts
- Taxpayer:
  - A irrevocable discretionary trust for the benefit of other parties than the grantor
- Federal Finance Court of 1992: A US testamentary trust would be treated as a corporate tax payer.
- German corporate taxation only kicks in if the place of effective management of the trust is situated in Germany.

J. Trusts and Income Taxes

- If the trust qualifies as a family trust that has not a registered office or place of effective management in Germany and was created to benefit the members of a family (which is the case if more than 1/2 of the trust property and/or income is ready for the settlor and/or his relatives) then a proportional share of the trust income is included in the taxable income of the settlor or those beneficiaries and remaindermen who are German residents.
- Exemption for EU/EEA trusts in case

  (i) the German beneficiary can prove that the trust property is extracted from the powers of disposition of the settlor and his relatives and

  (ii) Germany and the respective state have entered into a certain exchange of information agreement.
- Applicable also on US family trusts (see Art. 1 Sec. 6 US/German Income Tax Treaty)

J. Trusts and Income Taxes

- Tax consequences in the taxation regime pursuant of § 15 FTA:
  - (i) The positive different income types of the US family trust (as determined by German tax laws) are attributed to the German beneficiary on a pro rata basis if the beneficiary is a German resident.
  - (ii) The beneficiary is entitled to a foreign tax credit with respect of foreign income taxes the trust paid on the income.
  - (iii) Distribution of accumulated trust income that was subject to taxation in a prior year is not taxed a second time pursuant to § 20 Sec. 1 No. 9 ITA if distribution to the same person.
  - (iv) The same tax rate on the attributed income is applicable, which would be applicable in case the beneficiary would own the trust assets outright.
- Distribution of not attributed income or income distribution to a person to whom the income was not attributed under § 15 FTA is income taxable under § 20 Sec. 1 No. 9 ITA as a kind of dividend distribution. No distinction between recurrent distributions or distributions in a liquidation situation (BMF of May 6th, 2006, BStBl I 2006, 417). In literature doubted in case the beneficiaries do not have some kind of controlling rights like a shareholder. Revenue Service is defending § 20 Sec. 1 No. 9 ITA taxation.

J. Trusts and Income Taxes

- **Case:**

  A US trust is distributing trust corpus to the German beneficiary.

- Income tax consequences:

  - § 15 FTA rules do not apply. Trust corpus is no income.

  - § 20 Sec. 1 No. 9 ITA may apply!

  - § 20 Sec. 1 No. 9 ITA only excludes from income taxation repayments at the expense of the tax contribution account under the terms of § 27 German CTA.

- Trusts residing outside the EU cannot distribute at the expense of the tax contribution account because they do not have a tax contribution account.

- The German Revenue Service can take the approach that also the distribution of the trust assets is income taxable (see the discussion with *Dötsch* in: Dötsch/Eversberg/Jost/Witt, KStG, § 27, Rz. 14, Rz. 267; *Spilker/Perschke*, DStR 2011, 385 and also BFH, ZEV 2012, 58: A transfer which is exposed to gift tax should not be anymore exposed to income tax).

- Since January 1, 2009 the sale of a beneficiary designation in a foundation or a trust is capital gains taxable under the German flat tax regime (§ 20 Sec. 2 No. 8 ITA). Due to the grandfathering rules
  (Sec. 52 § 10 Sen. 4 ITA) it is arguable that the capital gains taxation should not apply on beneficiary designations granted before January 1, 2009 (but see also BMF of June 27, 2006, DStR 2006, 1227).

J. Trusts and Income Taxes

- **Methods to avoid § 15 FTA rules:**
  - Investment in US real estate
  - Investment in life insurance contracts
  - Interposition of an ordinary taxed subsidiary corporation of a trust which does not qualify under the German CFC rules
  - 50:50 concepts (e.g. combination with charitable lead trust etc.)
  - Escape into the EU/EEA exemption rule (US trust with dual place of management in the EU)
  - Escape into the § 20 Sec. 1 No. 9 ITA tax system: The yearly income of the trust is distributed within the same year to the German resident beneficiary.
  - Different accounts, so that it can be proven which part of the distribution is already attributed income in the meaning of § 15 FTA rules and which income is not attributed income.
  - Payments after the election in Art. 12 Sec. 3 made from the trustee to the beneficiary or to the remaindermen should not trigger German gift taxes again (see description in B., I of this presentation).
  - Any distributions from the trusts to the German beneficiary/remaindermen should not trigger German income taxation under § 20 Abs. 1 Nr. 9 ITA nor § 15 FTA-rules on undistributed income should apply anymore (totally open questions but see wording of Art. 12 Sec. 3 DTT; also unclear income tax effects of the election itself) because this income should be taxed directly in the hand of the beneficiary.

J. Trusts and Filing Obligations

- As a matter of precaution the beneficiary should notify the German Revenue Service that he is beneficiary of a US trust due to § 138 AO.
- He has to file special income tax returns for the FTA taxation under § 16 ff. FTA.
- Distributions of a trust to a German resident must be also notified within three months to the German Revenue Service (§ 30 IGTA), in case within ten years they exceed the personal tax allowance granted between the settlor and the beneficiary/remainderman.

L. Outlook

- **In outbound tax planning (Germany → US) make use of the treaty benefits! Right of taxation shall only rest with Germany!**
- **Make use of the US tax allowances under US domestic laws (including intangible property exemption)!**
- **Consider a life insurance planning!**
- **Consider the Treaty benefits for the surviving spouse before going to a QDOT!**
- **Check the Box may help!**
- **Consider Hybrid Trusts (but only with Private Letter Rulings)!**
- **Don’t forget the income tax!**

Many thanks for your attention!

FGS Flick Gocke Schaumburg

BAKER & MCKENZIE

Contact

Dr. Christian von Oertzen
Lawyer, Certified Tax Lawyer
christian.von-oertzen@fgs.de

Glenn G. Fox, JD LLM
glenn.fox@bakermckenzie.com