
Germany

International Estate Planning Guide

Individual Tax and Private Client Committee

Contact:

Henning Haarhaus

Kanzlei-Haarhaus
Germany

raha@kanzlei-haarhaus.de

Updated 1/2015

TABLE OF CONTENTS

I. Wills and Disability Planning Documents	1
A. Will Formalities and Enforceability of Foreign Wills.....	1
B. Will Substitutes	1
C. Powers of Attorney, Directives and Similar Disability Documents.....	2
II. Estate Administration	2
A. Overview of Administrative Procedures	2
B. Intestate Succession and Forced Heirship.....	4
1. Intestate Succession	4
2. Forced Heirship	4
C. Marital Property.....	7
D. Tenancies, Survivorship Accounts, Life Insurances.....	8
III. Trusts, Foundations and Other Planning Structures	8
A. Common Techniques.....	8
B. Fiduciary Duties	11
C. Treatment of Foreign Trusts and Foundations.....	11
IV. Taxation	12
A. Domicile and Residency	12
B. Gift, Estate, and Inheritance Tax.....	12
1. Tax Relief for Business Property	14
2. Real Estate.....	14
3. Transactions Between Spouses	15
C. Taxes on Income and Capital	15
1. Corporate Structures and Portfolio Management	16
2. Cross-Border Transfers of Shares.....	17

I. Wills and Disability Planning Documents

A. Will Formalities and Enforceability of Foreign Wills

German citizens who wish to write a will usually do so either by writing the entire text, dating and signing it or by having the instrument recorded before a German notary. Both types of wills have the same legal effect. The witnessed will, as known in many other countries, is only allowed as a provisional solution in cases of emergency. However, Germany has ratified the Hague Convention on the Conflicts of Laws Relating to the Form of Testamentary Dispositions of 1961. Therefore, a foreign will is formally valid in Germany if it either is established in accordance with the laws of the country of which the testator is a citizen, where the will is established, or where real property is located. As far as the choice of the applicable inheritance law is concerned, German law permits such choice only with respect to real estate assets and only in favour of German law.

German citizens as well as citizens of a jurisdiction whose laws stipulate a renvoi to German inheritance law are eligible for particular testamentary instruments offered by German inheritance law, namely joint wills and inheritance contracts. In the international context, many countries do not recognize or even forbid these testamentary forms. For example, in Luxembourg, Belgium, the Netherlands, Spain, Portugal, Italy and Greece, joint wills as well as inheritance contracts are not permitted. However, the EU-Regulation on Succession to come (also referred to as Rome V) will presumably alter the range of these German legal instruments. The new law to be enacted replaces the citizenship and the *lex situs* as connecting factors for the application of national inheritance laws by the last residence of the deceased.

The so-called Berlin will provides mutual appointment of each spouse as sole heir and of their children as final heirs. Berlin wills may provide a binding effect for the surviving spouse, because testamentary cross designations have a reciprocal characteristic similar to a contract. Such cross designation can be cancelled as long as both spouses are alive either by mutual agreement in writing or by serving the other spouse a revocation authorized by a notary. After one spouse dies, a Berlin will becomes binding unless provided otherwise in the joint will. The reciprocity can be ruled out in the will.

An inheritance contract stipulates a mutual binding agreement for both parties from the time of execution. Inheritance contracts may be useful if:

- the devisee plans to invest his money in property belonging to the testator during his lifetime;
- an intended transfer of a business *inter vivos* is to be flanked by a regulation *mortis causa*;
or
- extra marital partners who are not eligible for joint wills wish to achieve a similar binding regulation of their estate.

Whereas joint wills can be established in writing, inheritance contracts are subject to a notarial recording. Unless stipulated otherwise in the instrument, joint wills and inheritance contracts concluded between spouses are terminated without notice if the marriage has ended in divorced.

Irrespective of an existing joint will or the inheritance contract, the testator has the power to dispose of his assets while he is alive. After the death of the testator, an heir is entitled to claim back a donation if the decedent intended to impair the heir. As to an heir who may have invested his funds, time, or effort on the inheritance, the parties are well advised to conclude an additional contract prohibiting the owner to dispose of the estate assets while he is alive. Unless stipulated otherwise, inheritance contracts or mutual wills that have become binding can be contested with retroactive effect if one of the bound parties establishes a new familiar relation granting the new member a compulsory share. This would occur if the surviving spouse remarries or gives birth to additional children.

B. Will Substitutes

Since German law does not require a probate proceeding there has been no need for the development of will substitutes. In order to bypass an estate discretely, contractual death grants are generally used.

C. Powers of Attorney, Directives and Similar Disability Documents

Durable powers of attorney for health care and for property (*Vorsorgevollmacht*) are known in Germany and accepted both in the fields of property and care. They serve as means to bypass the appointment of a custodian by a guardianship court; the agent appointed in a power of attorney does not act under a court's supervision and control. However, a decision concerning medical treatment is subject to prior approval by the custodianship court when the principal is in imminent danger of dying or suffering irreversible damage. Court approval is also required to effect an involuntary commitment. Furthermore, the agent can represent the principal in such matter only if the power of attorney regulates so explicitly.

Powers of attorney empower the agent to dispose of the property and even to donate it. Accordingly, a property owner could arrange for a systematic transfer of property on a step-by-step basis irrespective of his current state of health. If the power of attorney entitles the agent to carry out real estate transactions, the signature of the principal must be authorized by a notary. If the agent wishes to take out a mortgage (e.g. in order to finance care and nursery services for the principal), the power of attorney must be recorded by a German civil law notary or the general consulate. As the legal reasons for a disposition are usually not documented in the instrument itself, their validity can be disputed if they are not clear or capable of proof. Unless self-dealing is explicitly allowed in the deed, a power of attorney does not create the legal grounds for the agent to keep property for himself. If there are indications of misuse of the power of attorney, a custodian can be appointed by the court who is authorized to control the conduct of the agent but not to act on his behalf. Another measure to prevent misuse of the power of attorney would be to grant a second individual power of attorney and thereby dividing the authorized actions between the agents.

Powers of attorney are generally deemed effective post mortem and must be revoked by the heirs. However, this principle has been significantly limited by recent case law. For this reason the power of attorney should provide clear regulations upon the death of the principal. Powers of attorney issued abroad should stipulate if they are intended to be effective in other countries.

Since only persons of absolute trust should be vested with a power of attorney, German law allows the regulation of directives for a future custodian to be appointed by the guardianship court as an alternative. In this directive, the future ward can stipulate nearly as many regulations as in a power of attorney. However, as the custodian is not entitled to make donations, such directive is not a proper tool for implementing a tax efficient succession plan.

Living wills are recognized and accepted in Germany. Generally, they must be executed in writing. However, in the event of an imminent operation, the oral form is sufficient. Living wills become legally binding if the patient becomes irreversibly unconscious. They serve as a means to indicate the presumptive will of the patient and they apply not only to situations shortly before death but also if the patient suffers from dementia or if he has entered a persistent vegetative state. The medical attendant as well as the custodian must verify that the patient has lost his decision-making capability and that the living will is applicable to the current situation. Therefore, the patient must accurately describe the measures in his living will to be taken in the event of his unconsciousness.

II. Estate Administration

A. Overview of Administrative Procedures

After the death of the testator, wills have to be delivered to the court where they are opened and brought to the attention of the individuals involved (i.e. heirs and disinherited relatives entitled a compulsory share). Afterwards, the court takes rather a passive role, because a probate is not known in Germany. Upon the heirs' application the court issues certificates of inheritance, which serve as an identifying document in regard to third parties such as banks or the land registry. The applicant for such certificate must provide information on the name of deceased and the date he died, his family relations, if he left a will, and if law suits are pending in regard to the estate. The correctness and completeness of the rendered information must be affirmed by an affidavit, which must be given before a German court, a German civil notary or a German general consulate.

In the course of the application for such certificate as well as in contentious proceedings, the proper interpretation of a will can be in question. As a rule, any interpretation must be consistent with the

intentions of the testator irrespective of the any possible recipient's viewpoint. A will can even be amended after the death of the testator if he articulated directly or indirectly a particular normative standard of fairness in his will and if the testamentary disposition does not correspond with these ideas owing to a change of the circumstances that occurred after the will was written (change of the estate's quality or quantity). In order to resolve an uncertainty of a will the parties may conclude a binding agreement on the interpretation of the will out of court.

Unlike in other civil law countries, there is no requirement for the heirs to file a declaration of acceptance regarding an estate in Germany. On the contrary, the heir must actively disclaim an inheritance by filing a notarized declaration with the court if he does not want to receive it. If the heirs have children they should arrange that their children also waive the inheritance. The waiver must be filed within six weeks from the time the heir received knowledge of the succession or the opening of the will. If the deceased had his sole residence abroad or if the heir was living abroad when the period started, the relevant time period is extended from six weeks to six months. After the expiration of the time limit, the heirs are personally liable for the debts of the deceased. For this reason they must take other measures explained below to limit their liability.

According to the principle of universal succession, the heirs step directly into the shoes of the deceased at the time of death. Several heirs form a community of heirs directly and become joint owners of the estate. As long as a community of heirs exists and holds an essential part of the assets forming the estate, the heirs' liability for the decedent's debts as well as for inheritance taxes is limited to the estate. The community of heirs has the responsibility of managing the administration and finally settling the estate. A majority vote of the co-heirs is required to take steps of administration. In urgent cases one heir can act for the whole community. Unanimous consent is always required concerning acts of distribution. Although the law suggests the liquidation of the estate into cash as a regular model of settlement, the heirs may mutually decide otherwise.

Unless stipulated otherwise in the will, an enduring administration of the estate cannot be achieved against the wishes of heirs holding a minority share, because each heir can file a motion for the partition of real estate by public auction as well as sue for the partition of the estate. In order to prevent conflicts among the heirs and keep estate assets in the hands of the family or particular family members, the testator can include provisions in his will that provide legacies in favour of particular heirs or third parties who obtain a respective claim for the surrender against the heirs. No obligation to equalize a grant arises if the asset is bequeathed to the heir by preferential legacy. The testator can also provide instructions for the apportionment of the estate. If one heir receives more than the value of his quota by complying with the instructed apportionment, such heir must compensate the co-heirs. The testator may also provide in the will that the estate must not be settled within the next 30 years after his death. However, by mutual consent the heirs can decide to override directives on the partition of the estate.

Despite the passivity of German courts in general, probate proceedings are not very common in practice. German law provides cancellation proceedings entitling the heir to refuse payment of the debts until the proceedings are closed. In order to establish or maintain a liability limitation, the heirs may also apply to the court for an administration of the estate by a court appointed administrator. This is only advisable if the estate is unclear and unmanageable for the heirs, e.g. if they live abroad and have no time and interest to care of the estate themselves. Heirs of an over-indebted or illiquid estate are obligated to file a petition for an estate insolvency proceeding without undue delay. Its initiation protects the heirs against the claims of creditors. If the costs for either court proceeding cannot be paid from the estate, the heir can plead the poverty of the estate. If the estate becomes over-indebted or illiquid on the grounds of legacies or other testamentary burdens, the heirs are entitled to release the total estate to the legatee instead.

Owing to the lack of a probate procedure in Germany, the appointment of an executor is not necessary in order to prevent a seizure of the estate by a court appointed administrator. However, if an executor is appointed in a will that was established in another jurisdiction, the appointment is valid in Germany unless otherwise provided.

The German Civil Code distinguishes between five types of executor appointments:

- The execution can be ordered for a limited scope like the arrangement of the testator's burial.

- The execution can serve as a means to enforce conditions that have been stipulated in a legacy (e.g. the handling of an art collection).
- The executor may be appointed to settle the estate as a whole or in part. In this case, his administration of the estate and his disposal of assets is only permitted as far as such measure would serve a settlement.
- An executor can also be appointed for the administration of the estate until the heirs have reached a settlement by mutual consent (e.g. the interim conduct of a business).
- Finally, a permanent execution may include both an administration and a settlement of the estate.

An ongoing execution can last for thirty years or longer if the execution will terminate upon the occurrence of an event related to either the heir or the executor (e.g. the heir reaches the age of 35 or the executor reaches the age of 65 years). Due to the separation of the estate from the property of the heirs, a permanent execution may serve as a shield against the claims of the heirs' creditors, thus making its asset protection effects comparable to a trust. A permanent execution of a will may also serve as an operational bypass for an interim period until an already designated successor finishes his training or occupational education. The provision of an execution of a will may also be advisable in a will of a young entrepreneur because normally his/ her heirs are still minors and cannot take over the business in case of emergency.

The basic duties are the seizure and inventory of the estate, the proper administration, the information of the heirs, the payment of taxes and liabilities, and finally the distribution. By combining a will providing an execution with a power of attorney, the designated individual would be able to act immediately on behalf of the heirs without having to wait for the issuance of the certificate of execution by the court.

As there may be a significant time lag between the establishment of the will and the event of death, the testator is well advised to either appoint supplementary executors in his will or authorize trustworthy individuals to name them. The appointment of corporations established for this purpose may serve as a proper measure to administer long-enduring and complex executions.

B. Intestate Succession and Forced Heirship

1. Intestate Succession

German intestate inheritance law distinguishes between different classes of heirs. The offspring of the deceased form the first class of heirs, the parents of the deceased and their offspring (including the siblings of the deceased) form the second class, and the grandparents of the deceased form the third class, the great grandparents and their descendants form the fourth class and so forth. Adopted children are treated equally to relatives by blood. Furthermore, the law is governed by the principles of:

- parenthood, i.e. the antecedent class of inheritors prevails over the subsequent classes,
- representation, i.e. children are represented by their parents, and
- replacement, i.e. children take the legal status of their predeceased parents.

A child who received an endowment from the deceased during his lifetime must compensate his siblings from his share in the inheritance if all children are equally called to succession. Upon request of one child the others are obliged to disclose such endowments.

The legal quota of a surviving spouse amounts to at least one quarter. However, depending on the matrimonial regime under which the married couple lived it may be larger (see below).

2. Forced Heirship

In principle, every German is free to dispose of his property at his own discretion during his lifetime or by reason of death. However, §§ 2303 *et seq.* of the German Civil Code stipulate the regulations on

the compulsory share for close relatives. In 2005, the Federal Constitutional Court affirmed these rules as constitutional and justified them as appropriate to protect the welfare state against claims of impoverished and disinherited heirs.

The regulations regarding the compulsory share do not have a direct impact on testamentary dispositions because they grant the disinherited relative/spouse a money claim. The disinherited individual has no right to participate in the estate and hence on the administration or the distribution of the estate. Like other estate liabilities, the forced share does not fall due unless claimed for. Furthermore, it becomes time-barred three years after the disinherited individual has become aware of the succession and his disinheritance.

The group of individuals who are entitled to a compulsory portion in the event of their disinheritance is limited to spouses/inscribed same-sex partners, heirs of the first class, or the parents of the deceased provided that there are no prevailing members of the first class. Other relatives, e.g. siblings, are excluded. The compulsory share amounts to half of the legal share that the disinherited would have been entitled to in an intestate succession. Thus, the portion is not fixed but depends on the familiar relations of the deceased (e.g. marital status, matrimonial regime, and number of children).

The values of the estate and of donations effected by the deceased up to ten full years prior to his death form the basis for the assessment of compulsory share claims. However, the heirs are released from one tenth of the respective burden for each full year that the deceased survived since his donation. The ten-year period does not begin to expire if the spouse benefited from such donation or if the donor did not dispose completely of his property (e.g. by reserving an usufruct for himself). In these cases, the full values of such donations must be taken into account. Life insurance policies for the benefit of a named individual are counted at their repurchase value.

In general, the devisees are opposing parties to claims for the compulsory portion even if the donation was effected to a third party. The nature of the forced share as a money claim implies that all assets of the estate must be taken into account irrespective of the jurisdiction in which they may be located. However, this does not apply for real estate located abroad if the foreign jurisdiction applies its own inheritance law as to the real estate. In order to prepare his claim, the disinherited individual is entitled to claim for an inventory listing the assets and liabilities forming the estate, including the donations to the heirs and third parties, and for the production of impartial appraisals regarding particular assets at the cost of the estate. He may also demand the heir to swear an affidavit on the completeness and accuracy of the disclosed information. For this reason, strategies resorting to lies and concealment, which may prove more or less fruitful to obstruct such claims, imply the risk of criminal prosecution. A different way of handling this issue would be to acknowledge the claims in advance, consider them in the estate plan, maybe even settle problems within the family while the testator is still alive and negotiate about a waiver of the compulsory portion. Unilateral strategies aiming at curtailing a potential claimant's portion may include: (i) donations acknowledging specific restraints, (ii) particular instruments provided by German civil law statutes or the common drafting practice, (iii) the establishment of structures and the integration of the claimant within the structures, (iv) the benefits granted by different matrimonial regimes, (v) a change of citizenship, or (vi) the acquisition of assets abroad.

Owners of country estates benefit from regulations facilitating the transfer of farmland to a sole successor. Thereby, low standard values instead of the market values are applied as the basis for the assessment in regard to both tax purposes and the compulsory share. This mode of appraisal looks to the profits gained from the property and neglects its material value. Unfortunately, only land/farm owners are eligible for the benefits for both donations and successions. Furthermore, they are granted wide tax exemptions granted for business properties, reducing the tax burden down to zero.

In their joint wills, spouses often appoint each other as their sole heirs and the children as final heirs (Berlin will, see above). This model of estate planning implies a disinheritance after the first parent passes away. As a matter of fact, children who were brought up in secure and socially functioning families tend not to claim for their share against the surviving spouse. Where this is not absolutely sure but the testator is reluctant to seek an agreement with the child waiving a future compulsory portion, the spouses can establish a clear incentive in their will and add a clause stipulating a forfeit of the child's designation in the second succession as final heir if he decides to claim for the forced share after the first succession. This sanction would leave the child only with a forced share in the second succession. Such sanction can be tightened further by granting the siblings who decide not to claim for

their compulsory shares in the first succession respective legacies equivalent to the portions to which they would have been entitled. However, the due dates for their disbursement are deferred to the time when the second spouse passes away. Thus, the legacies that arose in the first succession would count as estate liabilities in the second and thus reduce the value of the estate of the surviving spouse. A testamentary clause providing this scheme is referred to as a Jastrow's clause.

For spendthrift descendants, estate planning strategies should not aim at curtailing their compulsory share. Instead, the child is entitled to a full legal share. However, such appointment is only preliminary (*Vorerbschaft*); upon death or any other condition as stipulated in the will, the grandchildren or siblings may be appointed final heir or remainderman (*Nacherbschaft*). By arranging a prior heirship and reserving the share for a final successor, the testator keeps the respective share separate from the prior heir's own estate. Consequently, the share is beyond reach of the prior heir's creditors. He also cannot donate any assets belonging to the prior estate. Consideration received by the prior heir for selling movable assets becomes part of the prior estate. He cannot dispose of real property at all. Thus, the prior heir's entitlement is limited to keeping the gains generated by the estate as well as consuming the movable assets. In order to withdraw the power of disposal over the estate from the prior heir completely and to prevent a foreclosure of the profits by his creditors, the testator can appoint an executor, leaving for the heir only the nominal legal title. However, such factual dispossession of the prior heir cannot be accomplished against his wishes because he could opt for a waiver of his inheritance and his smaller but unrestricted compulsory portion instead. Therefore, the arrangement of a prior and final heirship in combination with an execution should always acknowledge sufficiently the interests of the prior heir. Furthermore, the advantages of this model should be weighed against the tax implications, because the successions of the prior heir and of the remainderman constitute two taxable transfers.

The establishment of a family holding entity, its appointment as sole heir and the step-by-step transfer of assets *inter vivos* may serve as an alternative means to at least defer claims for the compulsory portion and the ensuing drain of liquidity. The holding entity remains under the operative control of a trustworthy family member who is also a partner of the entity. The spendthrift heir is awarded a share in the estate equivalent in size and value to not more than his forced share. In contrast to the previously introduced solution, the heir cannot waive his share without losing anything in this scenario. On the other hand, an unwanted heir is still involved with the estate and will participate when the holding scheme has come to an end.

Increasing the number of close relatives who would have an intestate entitlement to the estate reduces the forced share of each one. Therefore, the adoption of an intimate or the marriage of a significant other may be considered.

The option for a community of property regime provides an alternative approach for curtailing forced share claims of the offspring. On one hand, this strategy would result in a higher nominal quota for the child, because the spouse's legal share would be reduced to one quarter. On the other hand, the less wealthy of spouse can thereby obtain an immediate gain of assets that is not deemed a donation in civil law and thus reduces the basis for the forced share. However, transfers of property by shifting the matrimonial regime are subject to donation taxation. Furthermore, it should be considered that the change would also effect an irreversible disenrichment of the wealthy spouse.

Converting from the German statutory matrimonial regime to a complete separation of goods and afterwards back into the statutory regime would incur a settlement of the equalization of the accrued profits gained during the marriage to the point of conversion (*Zugewinnausgleich*). The payment of the money claim arising hereof by the wealthier spouse reduces the basis for computing the forced share of the child at a later date, and it is also gift tax free. By converting back to the statutory regime, the spouse can benefit again from the spouse's increased intestate inheritance quota of one half resulting in a reduced quota for the child (for more information about changes between matrimonial regimes, see below).

The change of the testator's citizenship can be used to obstruct potential claims of forced heirship. According to German international inheritance law, the testator's home law determines the applicable inheritance law. If the testator's home jurisdiction does not recognize forced share rules and does not provide a renvoi to German law on the grounds of a status of residence, a change of nationality could be an effective strategy to circumvent forced heirship rules. Transferring assets into a jurisdiction that does not stipulate forced heirship rules would be suitable only in regard to real estate to be held in

direct possession of the owner and only in such jurisdictions whose laws provide the *lex situs*. This tactic does not apply to a transfer of other types of assets. Although sheltered abroad, perhaps even in a trust, the former owner may be sued in Germany to disclose all details of the transfer including the value of the assets. A judgment awarded subsequently could be foreclosed on properties located in Germany or elsewhere.

Plans of the European Union to enact a regulation on succession law have advanced recently (also referred to as Brussels V) abolishing both the citizenship rule and the *lex rei sitae*. The Europe-wide introduction of the residence as the sole connecting factor for the applicable inheritance law could lead to revision of the estate plan and the international allocation of assets.

Articles of business partnerships commonly stipulate that the share of each partner is to accrue to the share of the surviving partners after his death and that no severance money must be paid to the heirs. Such provisions benefit from the fact that transfers by means of company law have priority over the rules of succession. The model resembles the legal concept of joint ownership in Anglo-Saxon countries. In contrast to the joint ownership concept, however, transfers on the basis of German company law generally provide grounds for compensation claims for partners or their heirs. The clause described above aims at circumventing this consequence. If each partner shared an equal risk of predeceasing his co-partners at the time when the clause was adopted, an actual unilateral transfer without compensation favouring surviving partners over the heirs can be interpreted as the result of a "mutual lottery among the partners upon death" and thus of a reciprocal transaction. For the acceptance of such "lotteries upon death" it must be demonstrated that the risk to die first was spread equally among all partners in regard to age and state of health at the time when the articles of the business partnership had been established or amended respectively. If the requirements are fulfilled neither the share of the business nor a claim for severance pay will become an estate asset and thus are out of reach for a claimant demanding his forced share.

C. Marital Property

According to German international private law, the spouses' home law at the time of the marriage serves as the main connecting factor if shared by both, the jurisdiction of the common residence at the time of their marriage ranks second, and the jurisdiction to which the spouses have the closest relationship ranks third. Changes occurring after the marriage have no effect on the legal status. Spouses may deviate from these rules only by designating in a marriage contract either the laws of a jurisdiction of which one spouse is a citizen, of the habitual residence of one spouse, or of the *lex situs* in regard to real property. Such choice of law must be made in accordance with formalities required of the laws of either the jurisdiction where the deed is established or of the jurisdiction whose law is chosen as governing. In Germany, such choice must be notarized.

German national law provides three matrimonial regimes. Conversely to the perception even among many Germans, the statutory matrimonial regime in Germany is neither the community of property nor the separation of goods, but the joint ownership of the increase in capital value of assets. This rather abstract concept provides a money equalization scheme at the end of a marriage and has no effect on the ownership titles of the spouses. In order to facilitate the equalization upon death, German inheritance law entitles the surviving spouse an additional quarter of the legal share of the spouse (i.e. he/she participates with a share of one half besides co-heirs of the first class of heirs and with three quarters besides family members of the second class of heirs). However, instead of accepting the flat-rate inheritance, the spouse may waive it and claim for both the compulsory share and an accurately assessed equalization of gains to be computed as in a divorce. Since the claims are money claims, a spouse could avoid dealing with a complicated estate by taking this option, and after a long lasting marriage he/she could gain even more than by accepting the regular intestate succession.

In order to establish a community of property as the governing matrimonial regime the spouses must conclude a marriage contract by deed before a German notary. They can exclude particular assets from the regime. Except for unassignable assets (e.g. usufructs) the property of the spouses merges into one to be held jointly by both spouses. Although the authorization of one spouse by the other to administer the property may ensure more flexibility, the non-managing spouse may risk being taken advantage of. The community of property ends upon death, divorce, cancellation agreement, or by a judgment ordering its dissolution. However, spouses can stipulate that the matrimonial regime is to be continued with the heirs of a deceased spouse. Neither a spouse nor an heir can then assign their entitlements as long as the matrimonial regime exists. The legal share of a surviving spouse under this

regime is one quarter if the offspring of the deceased is called to succession as co-heirs. If relatives of the deceased belong to the second class, the spouse is entitled to one half of the estate in an intestate succession.

The establishment of the separation of goods regime is subject to a marriage contract that must be recorded by a civil law notary. Under this regime, no claims arise at the end of the marriage regarding the distribution of the property among the spouses. However, an undisclosed partnership between them could arise accidentally if one spouse collaborates in the business of the other and if he/she contributes essentially to the establishment of the business or its turnaround or if she/he increases the wealth of the other spouse by conducting the business. In this event, the spouse who is not named an official partner would be granted a compensation claim calculated based on the quality and quantity of the input at the time the collaboration ceases. Therefore, spouses who collaborate closely and pursue a common end in business are well advised to anticipate this legal situation in their estate planning (i.e. by establishing joint property in regard to particular assets such as a partnership organized under the German Civil Code (BGB company) or a commercial company).

The legal share of a spouse in an intestate succession ending a separation of property regime depends on the number of descendants. If there is only one child the share is one half. If there are two children, the share is one third. And, if there are three or more children the spouse's share is one quarter.

D. Tenancies, Survivorship Accounts, Life Insurances

Legal institutes like joint tenancies or joint accounts providing a legal assignment of the property to a co-owner in the event of death do not exist in Germany.

However, the transfer of assets by contractual death grant can be used to discretely bypass an estate de facto. Such donations in favour of a third party are not subject to the regulations regarding the formalities of a will. Cash value life insurance policies, savings accounts or securities deposits are commonly transferred. Examples include an insurance company or a bank promises the donor that the company will transfer funds to a named third party upon the donor's death. Such contract may be formulated as revocable or irrevocable. Death grants, irrevocable grants in particular, can be used as a tool to circumvent creditors of the estate, even if the beneficiary is also called to succession, because the asset does not become part of the estate. Therefore, if the transaction cannot be contested on the grounds that it was intended to defeat creditors' claims, the heir/beneficiary is in a position to receive assets and avoid the residual debt-ridden estate by filing a waiver. In principle, such contracts can be concluded in regard to other assets, too. However, as any transfer of real estate must be recorded by a public notary and entered in the public land register, discretion would not be maintained in regard to these assets.

III. Trusts, Foundations and Other Planning Structures

A. Common Techniques

German law offers various legal instruments designed to prevent the fragmentation of complex estates. By the appointment of prior heirs and final heirs/remaindermen with the latter simultaneously being appointed prior heirs in regard to the generations to come, it is possible to control the transfer of property over several generations by writing only one will. In this situation, the property never becomes part of the heirs' property. Moreover, individuals who have not been born can be granted an entitlement. In addition to the protection of indebted or mentally handicapped heirs and the preservation of family assets over generations, this legal instrument may serve as a testamentary means in a joint will to favour one's children who are not children of one's spouse as final heirs.

The establishment of a family holding entity may also be used to legally implement and organize a family strategy of wealth administration and succession. In comparison to the foundation, the holding entity grants weaker protection against fragmentation, because the partners may decide to end the structure. Alternatively, the articles of association can be easily modified, ensuring a greater flexibility of the holding structure. Family members may freely withdraw assets from the holding entity for their own use. Transfers of property into the partnership by one partner involve a donation to the other partners, who are also family members. Their enrichment implied with the transfer can be set off

against the value of their potential claims for compulsory shares to which spouses would be entitled if they decided to waive the inheritance.

The articles of association of a partnership serving as a holding structure needs not be recorded by a notary unless it is intended to own real property. However, such an agreement should be documented in writing. Suitable legal forms are either a BGB-company or the private limited partnership (*Kommanditgesellschaft, KG*). In contrast to the BGB-company, a KG must be entered into the commercial register. Thus, the existence of this legal entity, its purpose and the names and interests of the partners are disclosed to the public. A BGB-company allows greater secrecy. However, heirs who are underage have a statutory right to terminate their status as partners and thus their unlimited liability as partners after they have become 18 years old. Therefore, partners favouring the foundation of a BGB-company should adopt a clause within the articles of association allowing a revocation of the transfer into the partnership if the minor partner terminates the company. As a result, he loses his rights with retroactive effect without compensation.

If business property is involved, a business partnership (*Offene Handelsgesellschaft - OHG*), a corporation (*Aktiengesellschaft – AG*), or a limited liability company (*Gesellschaft mit beschränkter Haftung – GmbH*) may be considered. For different activities of the family or asset classes, different kinds of establishments may be worth considering.

An approval by the family court to the participation of minors is required only if the entity operates a business. Along with the appointment of the minor as a partner, the appointment of a curatorship limited to this partnership might be useful. If the family courts accepts a respective suggestion of the founder and appoints a close acquaintance of the donator as curator, the donating parent is relieved from the statutory duty of care regarding the minor's property. A divorced spouse thereby would have no opportunity to influence the holding entity by means of child custody.

If an estate consists of mainly one asset, making it impossible to grant every heir his share without jeopardizing the asset's existence (as it would be the case with a business), the testator can provide a legacy directing the other designated successor to enter an undisclosed partnership (*stille Gesellschaft*) granting him a share in the profits and losses of the business but no voice in the management. The typical dormant partner's participation is limited to his account balance as recorded in the balance sheet. He does not participate in asset values not disclosed therein, such as immaterial assets and good will. Therefore, the risks regarding the company's liquidity are manageable if the partnership ends. The rights of the silent partner are limited to inspecting the company's records. For the forenamed reasons, silent partnerships may serve as a useful tool to handle successions of small and medium-sized enterprises effectively by granting only such heirs a say in the business who are competent to conduct it. As the silent partner is not entitled to the same tax benefits granted to the successor of the business, this issue should be considered in relation to the partnership's size.

German foundations are commonly used as a legal form for charity organizations, because they are subject to approval and supervision of the government, which makes them trustworthy for other donors. German foundations are also popular because of the tax benefits granted for their establishment. Due to the turbulence in the German history of the 20th century involving the complete devastation of private and public assets, incorporated foundations have not been the vehicle of choice for private property owners. However, this has changed recently and in the last ten years the number of foundations has doubled. Whereas 600 private family foundations have been established so far, the assets of foundations acknowledged as charities in fiscal terms amount currently to approximately 90.000 €.

Apart from individuals wishing to serve the public welfare, foundations can also be established by enterprises in order to demonstrate their corporate responsibility. Foundations may serve as a means to protect and pursue a task considered by the settlor as his life achievement and to preserve it against fragmentation, may it be a business or an art collection or a historical building. Finally, a private foundation can serve as means of asset protection for individuals who practice in a profession involving risks of loss or whose family members suffer from squandermania. It may also serve as a testamentary successor of last resort if both the owner of a business and the designated successor become incapable of continuing it. An appointment of the foundation in this case would prevent the business from losing direction due to the lack of operative control or due to inheritance tax burdens. Inheritance tax burdens could arise if intestate heirs would otherwise receive shares of less than 25%, which would result in a forfeiture of the tax advantages granted for business successions.

Incorporated foundations are characterized by the absence of members, shareholders or partners who would influence the operation of the entity. Instead, the foundation's operation is driven by the purpose as stipulated in the foundation charter. Whereas incorporated foundations must appoint their own boards to operate their business, fiduciary foundations are administered by the board of the legal entity that holds the assets in trusteeship. Fiduciary foundations are suitable for assets in cash value of an amount that would not justify the costs of establishing and running a separate entity. Furthermore, a fiduciary foundation can be revoked more easily than an incorporated foundation, so that it may serve as provisional arrangement for donors who make their first steps in this field.

For grantors who wish to circumvent the government's approval and supervision of the vehicle, other structures resembling a foundation can be designed under use of private legal forms like the association (*Verein*) or the limited liability company (*Gesellschaft mit beschränkter Haftung - GmbH*). In order to achieve a form comparable to a foundation, the members/partners must not have the right to participate in the profits or in the proceeds of a liquidation. In comparison to a foundation, the choice for another legal form allows a greater flexibility in amending the articles of association by principally ensuring the same existence in perpetuity as a foundation. On the other hand, the partners jointly have the power to alter the articles of associations in a way not corresponding with the wishes of the founder. Moreover, charitable foundations offer better tax advantages than other charitable legal entities. Whereas a general inheritance and donation tax exemption applies to any legal forms serving the public good, foundations benefit from further tax allowances provided in income tax law. In addition to the common charitable deductions, endowments of one million € can be deducted from the donor's taxable income over a period of ten years.

The endowments of an incorporated charitable foundation must be sufficient for the pursuit of its purpose. The state supervisory authorities therefore require amounts ranging from 50.000 € to 150.000 € at least. German incorporated foundations are not required to spend a particular percentage of their capital per annum. Only the profits generated with the endowment are subject to charitable expenses in the year of their generation. However, foundations may accumulate income by saving up to 30% of their net earnings plus 10% further of such income that would be subject to immediate spending in the current fiscal year. A grantor and his close relatives are entitled to receive up to 30% of the earnings generated by a charitable foundation for maintaining an appropriate way of life. However, if the amounts paid to family members exceed a particular level such appropriateness could become a point of controversy with the fiscal authorities. Furthermore, the current interpretation of the term "close relatives" who are eligible as beneficiaries includes only two generations following the grantor at most. Finally, irrespective of its charitable purpose a foundation is considered a private family foundation if either the grantor or his family members are entitled to an interest of more than 25% in the foundation (annual profits and liquidation proceeds) and if other indices demonstrate a predominating interest of the family in the foundation. Therefore, a grantor who wishes his family members to benefit from a charitable foundation to an extent exceeding 25% should beware of a forfeiture of the tax benefits. As a measure of precaution he should not appoint himself or family members as members of the foundations.

The transfer of assets into a family foundation is subject to gift/inheritance taxation. The familiar relationship of the grantor to the last possible beneficiary determines the applicable tax bracket. Therefore, depending on the individual circumstances the gift tax burden for the transfer of 1,000.000 € into a private family foundation can be reduced to app. 90,000 €.

The periodical inheritance taxation of domestic family foundations every 30 years is a negative characteristic of this legal instrument, which makes it unattractive for estate plans drafted for longer periods. The expiries of these periods are deemed successions of two children to be taxed under tax bracket I. In order to avoid unpredictable taxation, a foundation charter might therefore stipulate its conversion into a charitable foundation before the expiry of such period.

Income of a family foundation is subject to corporation taxes of 15% if the profits are not paid out to the beneficiaries. However, as 95% of the dividends paid to a parent entity are tax free, they are taxed in total at a rate of app. 0.75%. Any distribution to the beneficiaries is subject to additional income taxation both on the corporate level and on the side of the beneficiary. Due to a lack of business activities a private family foundation is business tax exempt. Furthermore, distributions to beneficiaries are also subject to gift tax irrespective of the qualification of the foundation as charitable.

It is advisable that a family foundation should not operate a business by itself, but only hold its shares as a parent entity in order to allow increases in stock capital. Otherwise, corporate governance could not be maintained, because beneficiaries of a foundation have insufficient powers to control the executive board. For its acknowledgement as a charity the management of the foundation must be strictly separated from the executive management on the business level in order to avoid any influence on its operation. Apart from holding shares in a corporation or a limited liability company, a charitable foundation could also participate in a private limited partnership as a limited partner, because only the general partners are entitled to represent the company. However, a stake in the partnership exceeding certain limits would be deemed a commercial business operated by the foundation. In these cases the establishment of a GmbH could be considered as intermediary holding.

Ownership structures in a business organized as a GmbH could provide a combination of both a charitable and a family foundation as partners with differing participations in profits and voting powers. Whereas the operative control over the business is attributed to the family foundation the majority of the property value and the derived profits are attributed to the charitable foundation.

Every estate plan involving foundations or other legal entities whether they may be charitable or not, domestic or foreign, should always observe compulsory share entitlements of close relatives. These entitlements cease to exist ten years after the transfer of the assets.

B. Fiduciary Duties

Fiduciary duties and empowerments are regulated in the relevant instrument. In pursuing the founder's aim, the executives of a foundation must act with the due diligence of a prudent businessman. They must submit annual statements. In order to control the executive board, the appointment of a supervisory board of governors may be regulated in the instrument.

Testamentary executors and - if not relieved from such obligations - prior heirs must prepare an estate inventory. Furthermore, a final heir can demand from the prior heir that cash is invested in a manner eligible for a trust. He can also claim for a deposit of securities which would deprive the prior heir of his power to dispose of them. An executor is obligated to provide information on the course of the execution and to render accounts at the termination of the execution. Whereas a prior heir is only liable for his own tax burden, executors and boards of foundations are personally liable for managing the arising inheritance/income taxation issues. This rule applies also to boards and trustees of foreign entities.

C. Treatment of Foreign Trusts and Foundations

The acknowledgement of a foreign entity arises if a foreign entity holds property in Germany. In this regard, German legal custom to evaluate foreign foundations would apply if both the act of incorporation and the actual administrative office were located abroad. Following the judgments of the European Court of Justice ("Daily Mail," "Centros," "Überseering," "Inspire Art," "Sevic," "Cartesio") disallowing the office theory as breach of the freedoms as stipulated in Art. 43 and Art. 48 of the European Treaty, it was expected that Germany would change its view and adopt the incorporation theory. However, the legislators did not take action, and in a case involving a Swiss public company the Federal Supreme Court confirmed its stance in regard to those countries not belonging to the EU or the European Economic Area (Judgment of 27 October 2008 - II ZR 158/ 06). What is more, mistrust in the judiciary against foreign foundations as a whole is widespread, because foundations are regarded as vehicles facilitating tax evasion. This perception constitutes a handicap for their acknowledgment as can be seen in the judgment rendered by the Higher Regional Court in Düsseldorf on March 30th, 2010 (I-22 U 126/ 06) concerning a Liechtenstein foundation.

The German jurisdiction is often referred to as being hostile to trusts. The split of the ownership title as an essential feature of the legal concept stands in conflict with the doctrine of absolute ownership prevalent in continental law jurisdictions. According to the doctrine of absolute ownership, titles are regarded as indivisible. However, German courts have built bridges between the legal cultures of the common law and the continental law by acknowledging trusts. German courts have acknowledged trusts by interpreting the otherwise impermissible trusts with the legal instruments offered by German law in order to put the grantor's intention into practice. Hence, a testamentary trust is regarded as a will providing a permanent execution, and an *inter vivos* trust is interpreted as a condition imposed on a donation. Nevertheless, dealing with trusts in Germany is a complicated matter. The interpretation of

the deed always requires an act of adjudication by a court and any document must be translated into German by a certified translator. Accordingly, working with trusts in Germany is cumbersome and also tainted with uncertainty regarding the outcome.

In the field of taxation, trusts are treated equally to foreign family foundations, which may serve a similar purpose. Transfers into such foreign vehicle affected by an individual deemed an *Inländer* (with the unfavourable applicable tax bracket III) and payments to beneficiaries deemed as *Inländer* (see below) are subject to German donation/inheritance taxation. Conversely to German foundations, foreign vehicles are not subject to the periodical inheritance taxation after thirty years. However, income generated by a foreign family foundation is attributed to the grantor or the beneficiaries as their income if they are deemed *Inländer* for income tax purposes even if they have not received payments. In summary, foreign entities are unfavourable from a tax perspective as compared to German family foundations.

However, as of 2009, the tax value of businesses for purposes of the general tax rules can be reduced to zero (see below) thus making a tax burden of minor relevance for the choice in favour of a domestic or foreign family foundation in this regard.

IV. Taxation

A. Domicile and Residency

Individuals and legal entities being deemed *Inländer* are subject to German unlimited taxation on their worldwide income or property. Individuals or entities lacking this qualification are only taxable in regard to income sources or property in Germany as described in tax law (§ 34 of the Income Tax Code, § 121 of the Valuation Tax Act). In the field of income taxation the forementioned dualism is often amended by double taxation agreements with other countries. In the field of inheritance and gift taxes only a few of such bilateral agreements exist (Denmark, Sweden, France, and USA, Switzerland only in regard to inheritance taxes).

The *Inländer* concept is primarily based on the taxpayer's residence and the habitual abode. Provided that either the donor/deceased or the donee/heir has or had either residence or habitual abode in Germany all transfers of worldwide located assets are liable to the German taxes. A residence is defined as the maintenance of an accommodation fit for a permanent use irrespective of its factual use and irrespective of the center of life interests. As this definition targets the intention rather than on the facts, it is far wider than the definition provided for the habitual abode. Residence is not to be confused with the 183-days rule which refers to the term of the habitual abode. Legal entities are subject to unlimited taxation if either their actual administrative office or their registered office is located in Germany.

Although the citizenship of the individuals involved in the transfer is generally not a criterion for taxation purposes, German nationals are liable to further unlimited taxation for another five years after having moved away from Germany. An *Inländer* moving to a jurisdiction providing a low tax regime as defined in § 2 of the German Tax Act and maintaining essential property or business interests in Germany is subject to taxation to an extent similar to unlimited taxation for ten years as of departure from Germany (German nationals are subject to ongoing unlimited taxation from year 6 to 10 only). Unlimited taxation permits the allowance of foreign inheritance or gift tax imposed on particular assets located abroad.

B. Gift, Estate, and Inheritance Tax

Gifts and successions by reason of death are taxed equally in Germany. The succession/donation must be reported to the competent tax office within three months by the beneficiary (and by the donor, in cases of gifts). Banks, insurance companies, and trustees as well as the German general consulates must inform the tax office about the succession and the assets held as soon as they become aware. After being informed the tax office furnishes forms of the tax returns. Banks, insurance companies and other financial institutions may demand a tax clearance certificate from heirs who do not reside in Germany before paying out the balance/securities. This certificate is issued by the tax office after the taxes have been paid or after the tax office has determined that no tax obligation has become due.

The net estate is subject to taxation. All donations and successions occurring within ten years are included for tax purposes. After the expiry of this period personal tax exemptions revive respectively. Hence, one important estate planning strategy involves the donation of assets such as real property or securities on a step-by-step basis beginning as early as possible. As a further advantage besides a recurring grant of gift tax exemptions any rise in value of the property occurs in the hands of the younger generation. Liabilities of the deceased, liabilities of the heirs arising from legacies, compulsory shares, and a lump sum of 10,300.00 € in regard to costs for the settlement of the estate and the burial of the deceased may be deducted from the gross value of the estate.

Household and personal belongings may be tax exempt for spouses, inscribed same-sex partners, children, grand- and stepchildren unless their value exceeds 41,000 €. Minor children as well as spouses may claim an additional maintenance or retirement exemption. Leased property located in the EU is included at only 90% of its current value. For the succession of businesses particular deductions apply. In case of unlimited taxation personal tax exemptions for gifts and successions are granted as follows:

- 500,000.00 € for spouses and inscribed same-sex partners;
- 400,000.00 € for children, stepchildren and grandchildren whose parents predeceased;
- 200,000.00 € for grandchildren whose parents are still alive;
- 100,000.00 € for parents and grandparents in successions by reason of death; and
- 20,000.00 € for anyone else (e.g. siblings).

A family including a spouse and two children could thereby receive an estate totaling 1,300,000 € tax free with a properly written will. If grandchildren are involved such value can be increased by a further 200,000 € for each grandchild.

Transfers that are subject to limited German taxation only are tax exempt to an amount of 2,000.00 €. However, the European Court of Justice has recently ruled the different treatment of inheritors who are residents in Germany and those who are not a breach of the European freedom of movement of capital. Donations to German charities effected by the heirs within 24 months as of the succession that have not been stipulated in a will are deemed to be made in the context of the settlement of the estate and therefore are not only donation tax free but also inheritance tax free. Whether the restriction of this tax exemption to national charities only is in accordance with European freedom of movement of capital is very questionable.

The applicable tax rate depends on the familiar relationship of the donee/inheritor to the donor/deceased and on the value of the gift or their share in the estate. For recipients as mentioned below, the tax rates are as follows:

spouses, inscribed same-sex partners,	divorced same-sex
descendants and step children,	partners and spouses,
and parents in the event of death, of death,	parents in regard to and parents in the event donations, step parents,
and parents in the event of death	parents in law, siblings and their children
75.000,00 € - 7%	75.000,00 € - 15%
300,000.00 € - 11%	300,000.00 € - 20%
600,000.00 € - 15%	600,000.00 € - 25%
6,000,000.00 € - 19%	6,000,000.00 € - 30%

13,000,000.00 € - 23%

13,000,000.00 € - 35%

26,000,000.00 € - 27%

26,000,000.00 € - 40%

all above - 30%

all above - 43%

Any other recipients, including extra marital partners, are taxed at a rate of 30% if the net value of the estate/donation is below 6,000,000 € and at a rate of 50% if it exceeds this amount.

1. Tax Relief for Business Property

No other regulations in the IHT are more complicated than those concerning the taxation of business assets. In 2009, a new standard for the appraisal of business entities (also including shares in a corporation exceeding a ratio of 24.99%) was introduced. Beginning in 2009, the assessment of a business's value is based solely on the capitalized earning power. Furthermore, the Valuation Act provides two tax exemption models for the heir to choose from at the time he takes over the business. Irrespective of the model and his family relationship to the former owner he can claim to be taxed under the favourable tax bracket I which is otherwise reserved for the next of kin.

Both tax exemption schemes aim at preserving jobs for at least the holding periods regulated in the Inheritance Tax Act. The termination of the business, the sale of assets that are essential for its conduct or cash withdrawals during the prescribed holding periods exceeding the company's accrued profits by 150,000 € result in the forfeiture of the granted tax exemptions. A sale of the business as a whole would be tax neutral if the purchase price is reinvested within six months into another business. Tax obligations imposed on the succession of the business are deferred for up to ten years if the business would have to be sold in order to raise the tax amount.

The first model stipulates a holding period of 5 years and grants a tax allowance of 150,000 € and a further full tax exemption in regard to 85% of the business' value, i.e. only the residual 15% of the business value exceeding the allowance is subject to inheritance taxation. The second model results in a full exemption from taxes, but stipulates a holding period of 7 years.

Apart from the holding periods both models incur further legal requirements in two respects: Firstly, during the respective holding period the direct wage costs must not decrease for a specific percentage (above 50% in the first model, above 10% in the second) under the average of the wage costs paid in the last five years before the succession. This requirement does not apply to small businesses having 20 employees or less. Secondly, the quota of assets held by the company that are not essential for conducting the business (real estate used by or rented out to third parties, artwork, security portfolios) must not exceed a certain percentage in relation to the business' total asset value (50% in the first model, 10% in the second). No tax relief is granted if assets of the fore mentioned classes had been transferred into the business within two years prior to the succession/donation.

Estate planning may therefore include the following elements:

- Reduction of direct wage costs at least five years prior to the succession donation.
- Reorganization of passively managed assets as productive assets
- Outsourcing of unproductive assets into external entities
- Split-up of business into several entities in order to profit from both options
- Merger of small stakes in order to create a share of 25% or above that would be eligible for tax benefits.

2. Real Estate

Housing companies benefit from the same inheritance tax relief measures that are granted for businesses as explained above because of the particular importance of housing companies for common welfare in Germany. Currently, real estate portfolios are reshaped in order to meet the legal requirements defined by the fiscal authorities. Thereafter, they must be structured as corporations or

limited partnerships, the general partner being GmbHs (*GmbH & Co. KG*). Furthermore, the portfolio must generate annual revenues of at least 500,000 € or own at least 300 apartments. It remains in question whether the Federal Constitutional Court will approve such positive discrimination of extremely big properties on the grounds of their importance for the public good. For the handling of smaller rental properties the donation in combination with a usufruct reservation may serve as a suitable estate plan. The younger the donor, the larger the discounts that can be taken from the tax value of the property, because the deductible capitalized value of the usufruct depends on the average life expectancy.

Irrespective of their value, private family homes can be donated or bequeathed to a spouse tax free. However, in successions tax relief is only granted if the bequeathing spouse continues to live in the property for ten years after the succession. As to gifts, no such periods apply. Therefore, a married couple or inscribed same sex partners can in the course of a few years transfer several lots of valuable private real property located in EU or the European Economic Area countries (not Switzerland) taxfree among themselves.

3. Transactions Between Spouses

Due to widespread misperceptions regarding the German statutory matrimonial regime, spouses tend not to worry much about the consequences of asset transfers among themselves. In fact, such transfers may turn out to be subject to donation taxes in full. Apart from obvious benefits other situations are also considered donations in tax terms such as the payment of joint debts or mortgages by one spouse or the payment into a joint account, or the purchase of securities for a joint investment portfolio. The family home is the only exception. Even after many years, the fiscal office may gather information on undeclared transfers between the spouses by checking their income tax records or in the course of tax audits or on the grounds of reports filed by banks or insurance companies on the free-of charge assignments of securities accounts to which they are obligated as of 2009. As a consequence, transfers exceeding a total value of 500,000 € within ten years are taxed belatedly and interest is charged on the tax burden for a period starting three months after the donation has been effected.

A temporary change of the matrimonial regime may serve as an appropriate measure for eliminating these tax consequences with retroactive effect. The conclusion of a regime of separated property by notarial deed for at least one day ends the hitherto existing statutory joint ownership in value of accrued gains. By changing the matrimonial regime the account of accrued gains of each spouse is closed and a claim for equalization between them is to be calculated and settled. At first, the increase in value of the properties of each spouse during the marriage must be computed with zero being the lowest initial value. In a second step the balances of both spouses must be compared and equalized. As the service of such claim is gift tax free the values of prior donations can finally be credited against the resulting compensation claim. The spouses are free to revert back to their initial statutory matrimonial regime immediately afterwards.

However, the switch between the matrimonial regimes might have negative consequences in regard to income taxes, because the initially tax-free donation is now qualified as the grant of a benefit against payment, and real estate or participations in a German limited liability company in particular are subject to capital gains taxation. For this reason, the elimination of a donation tax must be weighed against possible negative income tax effects. Furthermore, the expected gains should outweigh the legal costs that are associated with the implementation of such a strategy.

A similar but less-than-ideal solution for a surviving spouse would demand from her a timely waiver of her inheritance and a claim for an equalization of the accrued gains to be computed as shown above and for her compulsory share. In this setting, the surviving spouse could argue that transfers received during the other spouse's lifetime were intended to be set off against the surviving spouse's claim for equalization of the accrued gains. However, such strategy would imply for the spouse a total abandonment of the estate, and a reluctance to give way to other heirs can only be overcome if the tax benefits are significant.

C. Taxes on Income and Capital

The scope of this guide would not permit more than a rudimentary overview on the German income and capital gains tax situation. Instead, the attention of the reader shall be drawn to three particular issues which occur regularly in the field of estate planning.

German income tax law generally distinguishes between personal and occupational activities. Whereas for instance in the real estate sector activities classified as private administration of assets aim at generating rental receipts, business activities seek to gain and realize profits from the increase of value by purchasing and selling real property. A change in the qualification of property management from personal to occupational that goes unnoticed may disrupt an equilibrium in the financial arrangements. Profits earned and losses incurred by the sale of real estate belonging to the personal sphere of a taxpayer are irrelevant in regard to capital gains taxes if the seller owned the property for over ten years. Conversely, profits and losses occurring in the course of a real estate business are always subject to capital gains taxation. Moreover, apart from such profits, the current income earned from rents is subject to an additional municipal business tax which can only be deducted in part from a respective income tax burden. Finally, as real estate is to be allocated to the operational assets on the balance sheet of a business, regular write-downs as permitted for fixed assets or private property are not allowed.

On the basis of the law of precedents rendered by the Federal Fiscal Court, in 2004 the Federal Ministry of Finance stipulated by ministerial order the criteria for classifying and distinguishing such activities in the real estate sector. A sale of three objects or less within five years is deemed personal. In this respect, only the sales of such objects are counted in the rule that had been part of the portfolio for less than five years. For owners who are professionally experienced in the building and construction business, the holding period is extended to ten years, because the fiscal authorities presume on the grounds of their knowledge, and irrespective of a long period of ownership, the initial intention of the owner at the time of purchase was to gain profits by a sale of the property and not only by the receipt of rents. Additionally, the three-object-rule represents only a rule of thumb. If significant assets like hotels, office buildings or factory sites are involved or if at the time of purchase indications of a sale in the future are on hand, like short-term lending arrangements or contacts to potential purchaser, the sale of two objects may alone be sufficient to assume a real estate business.

Domestic and foreign real estate as well as participations in real property investments funds exceeding either an investment amount of 250,000 € or a share in the funds of 10% are considered taxable objects in the context of the aforementioned rule. Purchase and sale activities of the management are transparent and may also have an influence on the investor's tax status. In contrast, inherited real estate does not count as an object unless the deceased operated a real estate business himself. Donated properties count as objects but the holding period of the donor can be taken into account in favour of the donee. However, donor and donee are considered one taxable subject in this regard, i.e. the three-object-rule applies to the joint activities of both property owners.

Real property owners who seek to restructure their asset investments are therefore advised to clearly separate their occupational from their personal ownership sphere by establishing separate business entities. Investments in real property investment funds - domestic or foreign alike - should be chosen according to the holding periods prescribed for their assets.

1. Corporate Structures and Portfolio Management

The profits earned by the sale of a business, a partnership in a business or shares in a legal entity held as personal property are subject to capital gains tax. Prudent entrepreneurs therefore use a holding structure when they start their business with the holding company ideally being organized as a GmbH. If the business is sold and the proceeds are not paid out to the partners of the GmbH the sale profit is taxed only at a rate of 1.5%. In other words, the entrepreneur has almost the whole purchase price to his free disposal for investments into new projects by using the GmbH as his investment vehicle. Income generated with these new investments would be subject to corporation tax of 15% plus solidarity surcharge and municipal business tax adding up to a total tax burden between 22.83% and 32.98%, depending on the municipality. For this reason the move of the taxpayer's residence and thereby the operational management of the GmbH from the industrial centres in Germany to the coast on the North Sea or to the Alps can imply tax savings of not less than 10%. Furthermore, the fore mentioned tax rates apply only to investments that are subject to full taxation, such as interest rates. Dividend payments or the profits earned by the sale of stockholdings are taxed much less. Conversely, dividends paid out of the investment vehicle to the shareholder are subject to a flat tax of 25% plus

solidarity surcharge and - if applicable - church tax. In the worst case, the overall tax burden on income generated by the GmbH and paid out to the partners could add up to more than 50%. However, by choosing a diligent asset allocation the tax burden can be reduced significantly.

2. Cross-Border Transfers of Shares

A partner or shareholder in a domestic or foreign legal entity who had his residence in Germany for five years and moves abroad is subject to the taxation of gains that occurred during his stay in Germany. The same applies if the share/partnership crosses the German border by means of succession or donation. For moves into countries belonging to the EU or the European Economic Area the consequences can be neglected because the tax is to be assessed but it needs not to be paid until the stake is finally sold. For moves into other countries like the USA or Switzerland the taxation is imminent. The tax obligation ceases to exist with retroactive effect if the taxpayer returns to Germany within ten years of his move while still owning the share/participation.