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By PwC Deutschland | 01. September 2023

Income tax on transfer of assets following dissolution of US-trust in part unconstitutional

The tax court of Muenster decided that the income from a dissolution of two US trusts be taxed as investment income in the hands of the beneficiary, except for income which accrued prior to 9 December 2010 (by protection of legitimate expectations).

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Background

In the year in dispute, the plaintiff received income from the dissolution of two U.S. trusts (irrevocable trusts), which had been established by his father and grandfather, respectively, as grantors. Both US trusts were irrevocable and had a term until the death of the father. The plaintiff and his sister were appointed as trustees, who had to manage the respective assets of the trusts. During the term of the trusts, the plaintiff's father was entitled to the entire net income from the trust he had set up. In addition, he received from the grandfather's trust those amounts that were necessary for his living support. The amounts were paid out at the discretion of the trustees.

After the death of the father in 2016, the assets from the US trusts were distributed equally to the plaintiff and his sister. Among the assets were securities, which the plaintiff sold at a loss in the same year. The plaintiff filed a corresponding inheritance tax return, in which he declared the assets acquired from his father's U.S. trust as a gift within the meaning of Sec. 7 (1) No. 9 Sentence 2 Inheritance and Gift Tax Act (IGTA). The transfer of assets from the grandfather's US trust was also declared in a gift tax return.

In addition, the plaintiff reported the distribution of the two trusts as foreign investment income in his income tax return. At the same time, however, the plaintiff and his sister pointed out that no income tax was payable because these amounts were already included in the inheritance tax return already filed. Otherwise, there would be an inadmissible double taxation.

The tax office nevertheless included the declared amounts as income from capital investment with reference to Section 20 (1) No. 9 Income Tax Act (ITA). The plaintiff objected - but without success. The case was then brought before the Muenster Tax Court.

Decision

The tax court of Muenster considered the lawsuit to be in part justified insofar as it related to income that had arisen up to 8 December 2010 (the date of promulgation of the Annual Tax Act 2010). In this respect the court found that a retroactive application of Section 20 (1) No. 9 ITA would not be possible with respect to the protection of legitimate expectations according to Art. 20(3) in conjunction with Art. 2(1) of the Basic Law, *Grundgesetz*.

Nevertheless, the criteria laid down in Sec. 20 (1) No. 9 ITA were met in the present case. According to this provision, taxable investment income also includes „*income received from a corporation, association or private estates which is not exempt from corporation tax within the meaning of Section 1 (1) No. 3 to 5 Corporation Tax Act (…)*“.

When applying a comparison of types both US trusts correspond to domestic corporations, associations of persons or estates. In the present case, the US trusts were structured in such a way that – for want of access to the assets of the two trusts during their existence – both US trusts had become legally independent. The trust assets transferred to the plaintiff in the course of the dissolution are therefore in general subject to Section 20 (1) No. 9 ITA.

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The distribution of assets from the dissolution of a U.S. trust is, according to the tax court, legally and economically comparable to the distribution of liquidation assets of a corporation. A statutory reason for dissolution existed in the present case due to the death of the plaintiff's father. The distribution of assets (comparison between net assets at the beginning and end of the winding-up period) in the present case also corresponded to the distribution of the liquidation assets of a corporation from an economic perspective.

In conclusion, the tax court once again pointed out that "double taxation" of one and the same circumstances with income tax and inheritance tax had been consciously accepted by the legislator at the time.

No retroactive application up to and including 8 December 2010

However, the court agreed with the plaintiff and saw a constitutionally impermissible retroactive effect to the extent such increases in value had arisen up to December 8, 2010. On that date, the Annual Tax Act 2010 was promulgated, which for the first time included foreign entities comparable to domestic corporations in the tax base.

Source:

Tax court of Muenster, decision of 23 March 2023 (1 K 478/21E). - No further appeal was lodged, **the decision is** thus **final and legally valid**.

Schlagwörter

Liquidation, trust