

Reform of the German Inheritance and Gift Tax Law

– Uncertainty for Business Successions

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Business successions bear a multitude of risks and have to be planned with due care. This applies in particular with regard to the tax consequences of succession, since a considerable inheritance or gift tax burden may hinder the continuation of the relevant business or may - in extreme cases of illiquidity - even cause bankruptcy. However, a careful consideration of the consequences of a business succession requires a reliable statutory basis, on which especially successions *inter vivos* can be arranged.

With regard to the German Inheritance and Gift Tax Law, there is currently uncertainty as to the future tax treatment of business successions. This is due to a recent decision of the German Federal Constitutional Court in which the court held that the current rules governing the taxation of inheritances and gifts are in breach of the German constitution. In consequence, the German Inheritance and Gift Tax Law will be reformed. This will particularly affect the existing rules granting preferential tax treatment for business assets. Therefore, resident entrepreneurs or foreign entrepreneurs with business assets in Germany should carefully observe changes in Germany's taxation of business transfers.

Current rules regarding business assets

In 1995, in a decision regarding the Inheritance and Gift Tax Law, the German Federal Constitutional Court ruled that the legislator is free to grant preferential inheritance and gift tax treatment to business property.

Currently, the preferential tax treatment of business assets results from a combination of the Valuation Law and the Inheritance and Gift Tax Law itself, which contains additional reliefs. At present, certain business property is taxed not on the basis of its fair market value, but on the basis of the assets' book value, which is usually considerably lower. On top of this preferential tax base, a valuation discount of 35% is granted, as well as an additional business property allowance of € 225,000. Finally, certain tax rate limitations apply. As a result, business

assets enjoy a much more favorable tax treatment than other asset classes.

Decision of the Federal Constitutional Court of November 2006

At the end of 2006, German inheritance and gift taxation was again subject to a decision of the Federal Constitutional Court. This time the court held that the existing German valuation rules are unconstitutional.

The current valuation rules differentiate between different asset classes; assets are not evaluated uniformly but in different ways. In general, assets are to be assessed at their fair market value. However, under the current rules the value of real estate, business, as well as agricultural assets turns out to be noticeably below the fair market value. Additionally, the current rules may have a random and arbitrary effect on valuation. According to the Federal Constitutional Court, this unequal valuation constitutes an unconstitutional unequal treatment.

The Federal Constitutional Court held that an equal tax burden for all taxpayers can only be achieved by evaluating all transferred assets realistically, which means that as a first step they must be assessed at their fair market value.

Nevertheless, according to the court, the legislator has the possibility of adjustment on a second level regarding the different asset classes. The legislator holds certain discretion to promote legitimate objectives. Provided there are sufficient grounds of common welfare, the transfer of certain assets may be favored by specific relief regulations. However, such promotion has to be pinpointed and must benefit a defined class of beneficiaries equally.

The court approved that additional rules providing a preferential tax treatment are acceptable in principle and need not necessarily be in breach of constitutional law. They may include specific tax allowances and deductions on the value for business assets, as already provided for in the current law (see sec. 13a Inheritance Tax Act).

On a third level, the legislator has further discretion to introduce tax rate amendments to promote certain legitimate objectives. It is therefore possible to introduce different tax rates for different asset classes. There are also no objections under constitutional law against limits as to the tax rate for certain classes of assets as the current law provides for business assets (see sec. 19a Inheritance Tax Act).

The Federal Constitutional Court's ruling will have no impact on an inheritance or a gift in the past, however, since the court held that the present rules are to be applied until they are revised and amended by the legislator. The court obliged the legislator to amend the valuation rules in question until December 31, 2008. By applying the current rules in the interim, a period of legal uncertainty shall be avoided; especially gifts made *inter vivos* shall not be hindered.

Future inheritance and gift tax rules regarding business successions

A reform of the German Inheritance and Gift Tax Law had already been intended before the Federal Constitutional Court's long-awaited judgment. As early as 2005, a draft "Law regarding the Facilitation of Business Successions" had been published. The draft introduced a special model for the preferential treatment of business property, allowing a business succession entirely free of tax provided certain conditions are met. However, since the named draft did not include any amendments to the applicable valuation rules, it became clear that the draft would have to be significantly revised to be brought in line with the recent decision of the Federal Constitutional Court.

A revised draft has now been published which includes new valuation rules to meet the requirements formulated by the Federal Constitutional Court. The valuation rules will be changed to the effect that every asset class will be valued at fair market value using standard valuation methods as used in non-tax-related contexts (e.g. the discounted cash flow method). Therefore, the reform of the valuation rules is likely to

result in a much higher tax base as opposed to the current situation.

This said, as the Federal Constitutional Court pointed out, the legislator has certain discretion to favor business successions. According to the scheme currently being discussed, 85% of the transferred business assets will not be part of the tax base, provided the successor meets certain conditions. One of these conditions could be that the business must be continued by the successor for a considerable time (possibly 15 years) along its basic structures. Moreover, there may be a restriction that no more than 50% of the underlying assets qualify as “passive” (e.g. real estate leased to others, widespread shareholding). These conditions are meant to ensure that, on the one hand, private investment assets are not transferred into business assets solely in order to obtain the relevant preferential tax treatment and, on the other hand, to secure the jobs provided by the transferred business. Moreover, an additional tax-exempt threshold (possibly €150,000) for business assets could be introduced which would allow small businesses to be completely excluded from the inheritance and gift tax assessment.

Due to aspects of party politics as well as the fact that the Federal States must participate, the legislative process as to the rules governing the taxation of inheritances and gifts is going to take considerable time. However, it is intended to enact new inheritance and gift tax rules by mid-2008.

Furthermore, plans to amend the relevant rules retrospectively as from January 1, 2007 are being discussed, but with the restriction that taxpayers shall have the right to elect whether the current or the new rules should apply for an inheritance (not *inter vivos* transfers!) during the 2007 assessment period. A retrospective enactment of the new rules demanding a mandatory application of the revised rules should not be possible, however, since the Federal Constitutional Court explicitly stated – to provide legal certainty – that the former rules shall remain valid until their amendment by the legislator. Therefore, taxpayers can rely upon the current rules until the revision is enacted into law.

Concluding thoughts

As the basic principles of the reform become more precise, so the appraisal of the efforts turns out to be double-edged. On the one hand, it must be appreciated that the legislator is willing to implement benefits for business assets into the new Inheritance and Gift Tax Law. On the other hand, it is questionable whether the intended regulations will provide an effective set of rules and sufficient benefits for business successions.

Firstly, it is highly arguable whether the market valuation methods used for real estate, agricultural property and especially business property are practicable for tax purposes. The economic valuation methods are complex and include a speculative component since future proceeds have to be estimated. Therefore, the intended new va-

luation rules will lead to an exaggerated administrative effort in every single case and might result in numerous court disputes.

Furthermore, it is questionable whether the discussed scheme grants satisfactory relief for business successions. According to the current reform plans, at least 15% of the transferred asset's fair market value remains Inheritance and Gift Tax assessable. Depending on the size of the business, this small portion may already constitute a tax basis able to trigger taxes in considerable amounts. Furthermore, the demand to continue the business for a long time period with a prescribed structure can turn out to be problematic. This prescription is extremely limiting to the successor's flexibility, resulting in a restriction of business potential. On the other hand, a strongly needed restructuring of the transferred business could mean the loss of the business property relief. Therefore, the discussed scheme might constitute a massive dilemma for the successor.

In conclusion, the approach currently discussed does not qualify as a sufficient legal framework for business successions. Furthermore, it once again gives rise to questions concerning its constitutionality. Since the parliamentary legislative process is also likely to bring several changes to the discussed schemes, the point in time at which a reliable statutory basis for succession planning will be re-established is uncertain.

For further information see the law firm profile at the end of the Handbook.



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