Reform of the German Inheritance and Gift Tax Law

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At the end of 2006, the German Inheritance and Gift Tax Law became subject to a far-reaching decision of the German Federal Constitutional Court: The court held that the valuation rules formerly applicable for the taxation of inheritances and gifts were unconstitutional due to the fact that the former valuation rules differentiated between different asset classes. Only some assets were evaluated at fair market value, others were assessed at a lower tax value. After more than three years of reform discussions, the German parliament passed the new Inheritance and Gift Tax Law shortly before the former law was due to lapse on December 31, 2008, as the Federal Constitutional Court had obligated the legislator to pass a reform by that date. The new Inheritance and Gift Tax Law came into force as of January 1, 2009.

New Valuation Law

Under the new law, all assets are generally assessed at their fair market value. In principle, business assets may now be assessed using a standardized capitalized earnings value method. This method is based on the capitalization of the historical average earnings of the business. The factor for capitalization is derived from an aggregate of a fixed interest rate of 4.5 percent and a basic interest rate that is to be determined by the German Federal Reserve Bank (approx. 4.0 to 4.5 percent). If the standardized capitalized earnings value method leads to obviously inappropriate results, other common valuation methods like the discounted cash flow method shall be applied.
Real estate is now assessed by different market valuation methods. Land is evaluated on the basis of the standard ground value; in the case of unfinished buildings, the manufacturing costs are added. Privately used residential property is evaluated using a comparison value method, whereas leased real estate is evaluated using a capitalized earnings method. The necessary capitalization factor depends on the remaining usage period. Nevertheless, the taxpayer has the possibility to prove a lower market value.
According to the new law, agricultural and forestry property is evaluated using a modified capitalized earnings method that takes the specialties of this asset class into account. The basis for the calculation is the pure profit that has to be capitalized by the fixed factor of 18.6. If the pure profit cannot be correctly determined, earnings are derived from the average agricultural and forestry rents as a minimum return. In case of a sale of all or parts of the agricultural and forestry property within 15 years, the property must be re-evaluated.
As before, cash, securities and other liquid funds are to be evaluated at fair market value. Listed securities are therefore evaluated on the basis of their stock exchange value.

Inheritance and Gift Tax Reliefs

The legislator also reformed the tax reliefs for the different asset classes. For example, real estate, business, as well as agricultural and forestry assets may benefit from preferential tax treatment. Since the Federal Constitutional Court held that reliefs must promote legitimate objectives and must be justified by sufficient reasons of common welfare, preferential tax treatment may only be obtained when compliance with narrow requirements can be verified.

Business property

According to the new law, business property relief is generally applicable to all business assets and agricultural property. Privately held shares in corporations (e.g. GmbH and AG) will qualify for preferential treatment if the owner directly holds more than 25 percent of the shares. However, minority shareholders have the option of pooling their shares to pass the 25 percent threshold.
Basic business property relief and an optional business property relief are available. According to the basic relief, 85 percent of the business assets will not be part of the tax base whereas 15 percent of the business assets will be taxed immediately. There is an additional tax allowance for a transfer of business assets amounting to a maximum of € 150,000. If the taxpayer chooses the optional relief, 100 percent of the business assets will not be part of the tax base.
Business property may only benefit from the basic relief if it does not contain more than 50 percent of so-called passive non-operating assets. Passive non-operating assets are, generally speaking, leased real estate, minority shareholdings of 25 percent or less, securities and cultural property. The optional relief is only available if the business property consists of no more than 10 percent of non-operating assets. Where the 50 percent and 10 percent requirements respectively are satisfied, passive non-operating assets may only benefit from the business property relief if it has been part of the transferred business two years prior to the transfer.
The business property relief is intended to safeguard jobs at the transferred businesses. Therefore, for basic relief the total sum of wages and salaries paid during the seven years following the transfer must be at least 650 percent of the historical average of the total wages. To benefit from optional relief, the total sum of wages and salaries after ten years must be 1000 percent of the historical average of the total wages. Smaller businesses with ten or fewer employees or an historical average of salaries and wages of €0 (nil Euros) are not subject to these rules.
Furthermore, in order to benefit from the basic relief, the transferee must hold on to the business assets for at least seven years. In case of a sale or abandonment of a business within seven years following the transfer, the transferee partly loses the business property relief. The reduction of the business property relief depends on the time that has passed after the transfer up until the sale. An exemption is made if the sale of an independent division of the business or of essential assets is not aimed at the retrenchment of the business and if the proceeds of the sale are reinvested in the interest of the business. In the case of optional relief the compulsory holding period is extended from seven to ten years.
Foreign business property and interests in foreign corporations are eligible for preferential treatment in cases in which the property or interest is effectively connected with a permanent establishment in a state of the European Union or the European Economic Area. Preferential treatment of directly held shares in corporations requires that the company's seat or effective place of management is located in the European Union or the European Economic Area.

Real estate

The Federal Constitutional Court held that the concerns of the construction and housing industry and especially the development of personal property may justify a preferential inheritance and gift tax treatment of gratuitous transfers of real estate. Thus, the new law contains a real estate relief which distinguishes between residential property and other real estate.

Under certain conditions, leased out residential property which is part of a business may be subject to the basic or the optional business property relief under the circumstances described above. It is not regarded as passive non-operating assets for the 50 percent and 10 percent tests respectively. Privately held leased out residential property benefits from a 10 percent tax base deduction only.

The transfer of an owner-occupied residential property (family home) between spouses or civil partners, as well as to descendants, may be completely free of tax. The transfer of the family home inter vivos between spouses and civil partners is free of tax if the family home is the family center of the couple. The transfer of the family home to spouses, civil partners, as well as to descendants upon death, is also free of tax, but only if the heir uses the family home for the following 10 years as his or her main place of residence. In case of a transfer upon death to descendants, there is a 200 square meter size limit.

Other real estate does not benefit from the relief. If the transferee could only afford to pay the taxes by selling the real estate, he or she is entitled to a general interest-free tax deferral.

Tax rates and tax allowances

The tax rates for core family members (spouses and descendants; parents and grandparents in case of inheritance) are unchanged and range from 7 percent to 30 percent depending on the value of the transfer received by each transferee. The tax rates have been changed for more distant relations (siblings, nieces and nephews, aunts and uncles, etc.) and unrelated taxpayers. The former distinction between distantly related and unrelated taxpayers has been waived. The tax rate is now uniform at either 30 percent (if the value of the individually received transfer is € 6 m or less) or 50 percent (if the value is above € 6 m).

Personal tax allowances have been raised to absorb the increased asset values. Spouses receive, inter alia, a maintenance tax allowance of € 256,000 and a personal tax allowance of € 500,000. Children or grandchildren of the transferor receive a personal tax allowance of € 400,000 and € 200,000 respectively. Parents or grandparents receive a personal tax allowance of € 100,000 if they inherit assets from their descendants. Civil partners do receive the same maintenance and personal tax allowances as spouses, but remain in the tax bracket for unrelated taxpayers. All other transferees receive a personal tax allowance of only € 20,000. Personal tax allowances can be claimed again every ten years, making lifetime gifts attractive.

Conclusion

Under the new law, business, real estate and agricultural property may benefit from extensive reliefs. Nevertheless, it remains questionable whether the intended regulations will provide an effective set of rules. In particular, the new market valuation methods might not be practicable for tax purposes. This may lead to an increased number of valuation disputes.

Due to the new valuation rules, the transferee and the transferor respectively must bear the risk that the transfer may trigger taxes of considerable amounts, especially where business property relief may not be obtained. Particularly the demand to continue the business for a long time period with a prescribed structure in order to fulfill the requirements for a preferential tax treatment may turn out to be problematic. This prescription imposes strict limits on the successor's flexibility, resulting in a restriction of business potential.

In conclusion, the new Inheritance and Gift Tax Law once again gives rise to questions concerning its constitutionality. This holds true especially for the valuation of agricultural and forestry property and the taxation of real estate other than residential property. The new law also creates an excessive administrative burden. In the meantime, taxpayers must resort to tax structuring to minimize their tax liability.

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Alongside the family office/asset management and the real estate practice, more than half of the 95 attorneys and tax advisors in Berlin, Munich and Frankfurt specialize in legal and tax advice on transactions. The Berlin-based family office/asset management practice of **Dr. Andreas Richter** and **Dr. Jens Escher** concentrates on the legal and tax advice regarding international and national asset management and structuring, succession planning for individuals, emigration and exit taxation, as well as the setting up and structuring of foundations, family companies, family pools and family offices.

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