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An Examination of the Influence of Inheritance Tax upon Business Succession - Lessons for Germany

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Abstract

Family enterprises form the backbone runnieSahtl4(y2ex5.8ny.8Those6.8(sse)797.2(rai5ue-r)10L7 492.2401(rm)7/yl(Vsj/8s5o(4R0 -n)5.8(m 3lsJ4(y)-0
and in the next years to be given to the following generation.

[1] Accordingly, business succession will be an important task to be handled. Following recent statistics, about 350,000 companies with approximately 3,400,000 employees in Germany have to be transferred in the next five years.[2] From this point of view, business succession can be

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[1] See Kohli, M./Künemund, H./Schäfer, A. et al. (2006), p. 58.
[2] See Institut für Mittelstandsforschung (ed.) (2005).
[3] See Spiegelberger, S. (2007), p. 354.

role.[4] The inherent complexity leads to specific challenges for the senior generation as for the successor.[5] The general aim of a business succession – not only from the successor's personal point of view, but also from a German constitutional perspective,[6] is to guarantee the survival of the company and its jobs as well as the economic existence of the successor in the long run.[7] For closely held companies, especially if held by a family, the going concern of the company under family supervision can be an aim itself.[8]

Almost 95% of all companies existing in Germany are managed by families. Each year nearly 71,000 companies are to be transferred,[9] and in the past approximately 44% were succeeded by a relative.[10] Intra-family business succession is generally not on a (100%) for-money-basis, so gift and inheritance taxes have a major influence on structure and timing of business succession. Accordingly, tax optimisation is seen as an important task in the process of planning such kind of succession.[11]

Inheritance tax has to be paid out of the successor's property and thus can lead to an extraordinary reduction of liquidity.[12] As business succession is not normally planned under liquidity aspects, the successor has to liquidate his private property and may even be forced to extract liquidity from the business.[13] This can lead to a lack of liquidity at the company level and may even threaten its going concern.[14] To resolve such problems, the German tax system provides a tax deferral in such cases,[15] but as it is subject to strong restrictions, it is of low importance for the praxis of succession planning.[16] Additionally, these regulations only shift the tax burden in time without abolishing it, so they lead to a mere time effect.[17]

The European Communities see causality between the failure of business succession and the connected tax burden[18] and are regularly confirmed in their opinion by scientific literature.[19] Even as there has not been any empirical proof for this assumption, it can be seen as a major reason for the ongoing discussion of inheritance tax reforms in Germany.[20]

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[4] See Friedrich, K./Steidle, B./Gunzelmann, U. (2006), p. 19.
[5] This can be seen easily by counting the amount of information brochures and practical guidelines of chambers of commerce and professional associations. See e.g. Industrie- und Handelskammer Baden-Württemberg (ed.) (2005); Deutscher Industrie- und Handelskammertag (ed.) (2004); Bundessteuerberaterkammer (ed.) (2007).
[6] See Art. 14 Abs. 2 GG.
[7] See Steuerberaterkammer Stuttgart (ed.) (2006), p. 6.
[8] See Watrin, C. (1997), p. 18.
[9] See Bundesministerium für Wirtschaft und Technologie (ed.) (2007), p. 12.
[10] See Gesmann-Nuissl, D. (2006), p. 2; Bundesministerium für Wirtschaft und Technologie (ed.) (2007), p. 38.
[11] See Watrin, C. (1997), p. 18 ff.
[12] See Lehmann, D./Treptow, O. (2006a), p. 413.
[13] See Karle, M. (2006), p. 12.
[14] E.g. see Schaumburg, H. (2006), p. 22.
[15] See § 28 ErbStG.
[16] See Schulte, W. (2007), p. 320.
[17] See Scheffler, W./Wigger, B. U. (2006), p. 2445.
[18] See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994), p. 2.
[19] E.g. see Schaumburg, H. (2006), p. 22; Scheffler, W./Wigger, B. U. (2006), p. 2445.
[20] See Ziegler, J. (1996), p. 454.

Using the British inheritance tax system as a blueprint has been suggested several times in the past by the European Commission[35] as well as in literature[36] and was topic of general discussions. [37] The Commission even directly recommended the British model for tax system reorganisations in the EU member states,[38] and as recently as European Autumn 2007 the International Fiscal Association (IFA) discussed the advantages for Germany in learning from Great Britain in the field of taxation of business successions.[39] For this reason, the research project described on the following pages was based on British inheritance tax law.

2.2 Theoretical framework

The research project is based on a hypothetic-deductive understanding of science,[40] leading to a general research structure of (1) definition of hypotheses, (2) evaluation of variables and (3) test of the hypotheses based on empirical primary data. In this context, the term "hypothesis" is understood as an assumption of causalities with the aim to identify interrelations (instead of the measurement of stand-alone variables).

In social sciences, an empirical theory is seen as a system of hypotheses that (a) are using well-defined terms and (b) are free of discrepancies.[41] The discussion of possible inheritance tax reforms has lead to several assumptions of interrelations, none of them yet being tested by scientific research yet.[42] For this reason, they are used for deduction of general research hypotheses as well as for theoretical discussion of probable decision effects of inheritance tax systems. Personal experience in tax advisory for business successions is added.[43]

2.3 Methodological framework

Following the above-mentioned understanding of sciences, emphasis has to be set on the scientific test of hypotheses.[44] The analysis methods and instruments are taken from the area of empirical behavioural research in socio-economics:

Empirical reality exists in natural situations or can be designed artificially. Accordingly, empirical research offers different methods for controlled and systematic data evaluation. Basis techniques for primary data evaluation are interrogation, observation, analysis of contents as well as so-called non-reactive evaluation methods,[45] the latter two not being appropriate for this research context. Observation in the sense of participation of the scientist obviously has to be excluded in the area of inheritance tax. What remains is the interrogation as first-best method. The research design has to follow this conclusion.

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[35] See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994a), p. 1.
[36] See Ritter, W. (1994), p. 2290; Ziegler, J. (1996), p. 456.
[37] See Kühn, A. (1996), p. 11; Albrecht, P. (1997), p. 482.
[38] See Kommission der Europäischen Gemeinschaften/Commission of the EU (1994b), p. 12.
[39] See Richter, A. (2008), p. 59 ff.
[40] See Kromrey, H. (2006), p. 85 f.
[41] See Kromrey, H. (2006), p. 52.
[42] E.g. see Bundesverband der Selbständigen/Deutscher Gewerbeverband (ed.) (2004), p. 3;

The results of a first survey described in chapter 5 are based on information of 20 participants. The tax professionals that have been interviewed are divided into three categories of experience (CE). The categorisation has been done particularly with reduction of 50% or even 100%. Thus, inheritance tax can be avoided partially or totally.

In order to make use of such incentives, the following conditions must be fulfilled:

a) The fundamental condition for accessing the incentives is the existence of an active trading operation (IHTA 1984 s 105(3)). The aim of the regulation is the exclusion of investment companies from gaining access to the incentives, so the condition can be seen as an activity or productivity clause. In the case of mixed use for trade and production (being active) as well as for investments (being passive) the incentives are restricted to assets used wholly or mainly for active operations. In order to determine which part of a company can be transferred with a reduced or nil tax burden, the balance sheets have to be analysed to separate active from passive property.

b) Incentives are possible only for business assets that are not used for activities defined as excluded business.[61] Exclusion is mainly for activities such as trading shares, trading real estate or holding participations. An exception exists for holding companies with subsidiaries not conducting excluded business.[62]

c) Business assets subject to a binding sales contract cannot access the incentives, even if they fulfil all other conditions.[63]

d) In addition to assets that are used in excluded business activities, single assets (known as excepted assets) can also be excluded from tax incentives. Excepted assets are characterised by not being used mainly for business purposes in the past two years and not being planned for business use in the following two years.[64] Excluded assets can not be included in the amount designed for BPR incentives.[65]

e) In order to gain access to the incentives, business assets must have been kept in the transferor's property for at least two years prior to the transfer.[66]

The incentives can be used only for the above-mentioned relevant business property and result in either a 100% or a 50% reduction of the taxable amount.[67] The 100% reduction, i.e. the full tax exemption, is possible for the transfer of the following assets:

a) Business and interest in a business including sole proprietorships and partnerships.[68]

b) Above 50% of securities in a non-quoted corporation as well as non-quoted shares in corporations without a minimum participation requirement.[69]

The 50% reduction, i.e. 50% tax exemption, is allowed on the transfer of:

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[61] See IHTA 1984 s 105 (3).
[62] See IHTA 1984 s 105 (4)(b).
[63] See IHTA 1984 s 113.
[64] See IHTA 1984 s 112 (2).
[65] See IHTA 1984 s 112 (1).
[66] See IHTA 1984 s 106.
[67] See IHTA 1984 s 104 (1)(a) and (b).
[68] See IHTA 1984 s 105 (1)(a).
[69] See IHTA 1984 s 105 (1)(b), (bb).

a) More than 50% of the securities of a quoted corporation;[70]

Additionally, the written questionnaire was sent out with support of the Society's of Trust and Estate Practitioners (STEP) Worldwide Office in London. The second survey covers about 200 members of the Family Business Special Interest Group at STEP and as far as possible gives a guarantee as to the practitioners' expertise in gift and inheritance tax advisory. The questionnaire was sent in Summer 2008 via email by STEP's Chief Executive, and return is still ongoing. Several reminders have been sent.

The willingness of tax professionals to participate in the survey was very low. A possible reason for this may be because tax advisors and solicitors currently have large workloads due to the announcement by the legislator of further essential changes of the British tax law. This would, in many cases, require a form of financial compensation to be given to advisers as an incentive for them to participate in a

5. RESULTS OF THE SURVEY

5.1 Preliminary remarks

In the following we describe the results of the survey among British tax professionals concerning the general effects of the inheritance tax on business succession as well as effects of specific regulations of the British Inheritance Tax Act.

The figures show the results over all of the three categories of experience and additionally the evaluation of the participants with the most experience (CE 3). One participant represents 5% (over all CE) respectively 7,7% (CE 3). The percentage values in brackets that are mentioned under the figures show the evaluation that has been given by participants with most of experience (CE 3).

The categories of answers consist of "very strong", "strong", "rather strong", "rather weak", "weak" and "very weak". If one of these categories does not exist in the evaluations, it is not shown in the respective figure.

5.2 General effects of the inheritance tax on business succession

5.2.1 Liquidity burden and way of succession

Figure 2 shows if there is a connection between the liquidity burden due to taxation and whether the business succession occurs within the family (internal succession) or by external succession, typically by selling the enterprise. If there is a connection from experience, the figure illustrates also the strength of this connection.

FIGURE 2: LIQUIDITY BURDEN AND WAY OF SUCCESSION

15% (15,4%) of the professionals are of the opinion that business successions occur within the family despite the higher liquidity burden. The reason for this is the expectation of the successors that the liquidity burden can be compensated after the enterprise has been successfully continued within the family for some years. However 45% (46,2%) believe that the higher the liquidity burden, the more probable an external succession becomes. 40% (38,4%) state that there is no connection between the liquidity burden due to inheritance tax and the way of succession.

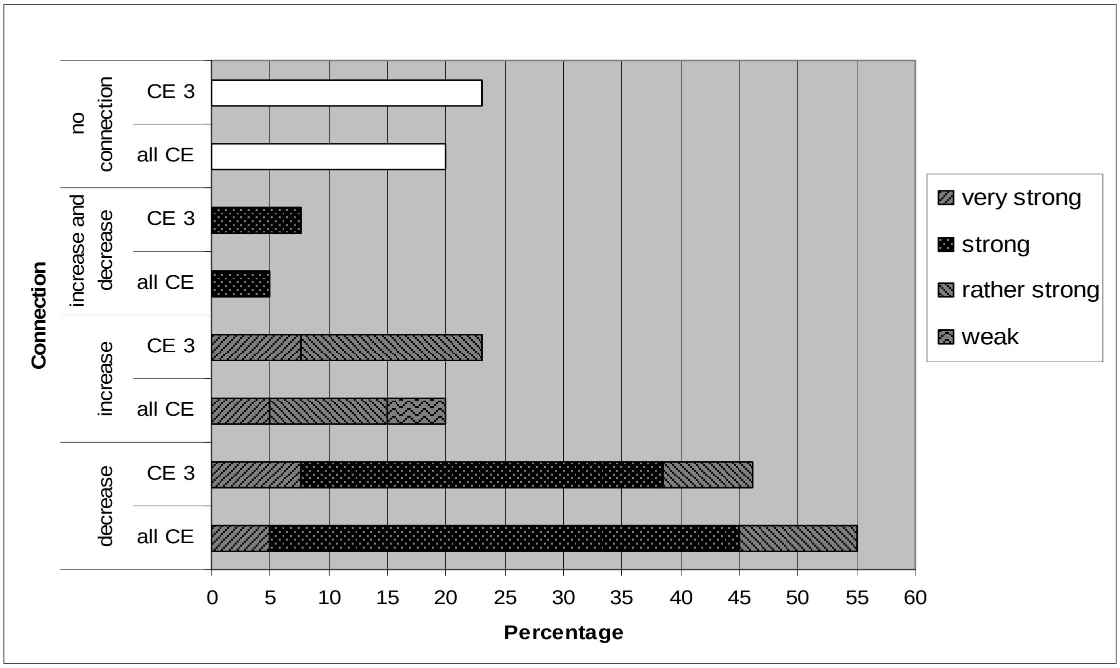
5.2.2 Liquidity burden and continuation of the enterprise

Figure 3 shows if the participants believe there is a connection between the liquidity burden due to taxation and greater probability of either the continuation of an enterprise by the successor or the termination of the enterprise at a later date. The strength of this possible connection is also shown.

FIGURE 3: L

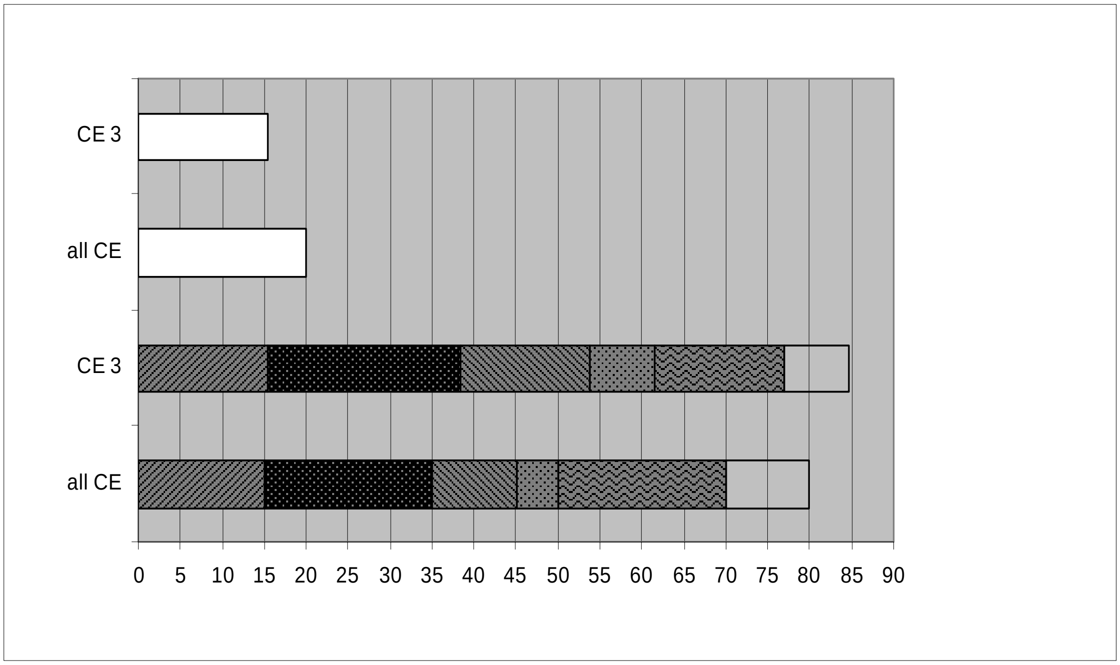
connection between the level of the tax burden and the volume of the transferred assets and how strong this possible connection is.

FIGURE 4: TAX BURDEN AND VOLUME OF THE TRANSFERRED ASSETS



60% (61,5%) declare that the composition of the assets has the aim of realising the

FIGURE 6: TAX BURDEN AND WILLINGNESS TO MOVE ABROAD



5.2.6 Preferential treatment of business property to ensure business succession within the family

Figure 8 shows the personal opinion of the participants concerning the question if the preferential tax treatment on the transfer of business property is necessary to ensure the business succession within the family.

The preferential tax treatment on the transfer of business property to ensure the business succession within the family is confirmed by 90% (100%) of the interviewed tax professionals as a necessary measure. They evaluate the preferential tax treatment as "absolutely necessary", "necessary" or "rather necessary", and can be summarised as necessary overall. Only 10%, (solely participants who are categorised in CE 1 and 2), negate this necessity.

FIGURE 8: NECESSITY OF THE PREFERENTIAL TAX TREATMENT OF BUSINESS PROPERTY

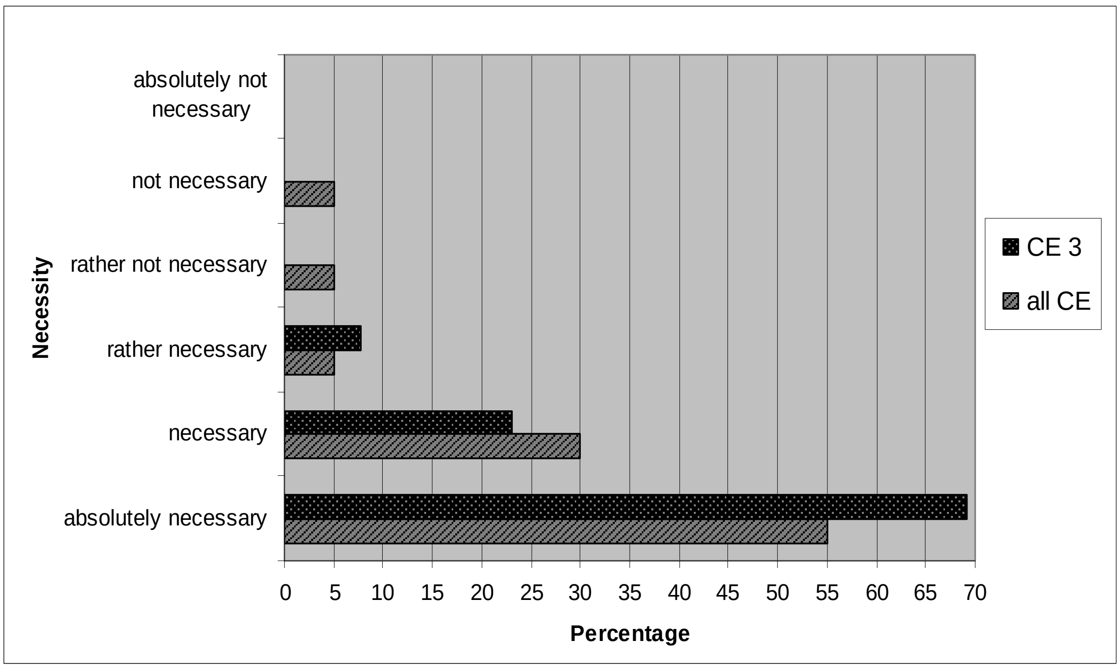


Figure 9 shows the reasons the participants mention as justification of a preferential tax treatment on the transfer of business property to ensure the business succession within the family. The level of importance of each reason is also shown in the figure.

Securing of employment, investment activity and capital base of a transferred enterprise as reasons for a preferential tax treatment are confirmed by 80% (92,3%) of the respondents. 75% (84,6%) evaluate each of these reasons as "very high", "high" and "rather high", showing they have an overall high importance.

The possible limited saleability of business property is seen as another reason for preferential tax treatment by 75% (92,3%) of the interviewed tax professionals. An overall high importance is confirmed by 40% (38,5%). 35% (53,8%) evaluate this reason as being of "rather low", "low" and "very low" importance. Based only on the evaluation of participants who are categorised in CE 3, this reason has an overall low importance.

FIGURE 9: REASONS AND IMPORTANCE OF A PREFERENTIAL TAX TREATMENT

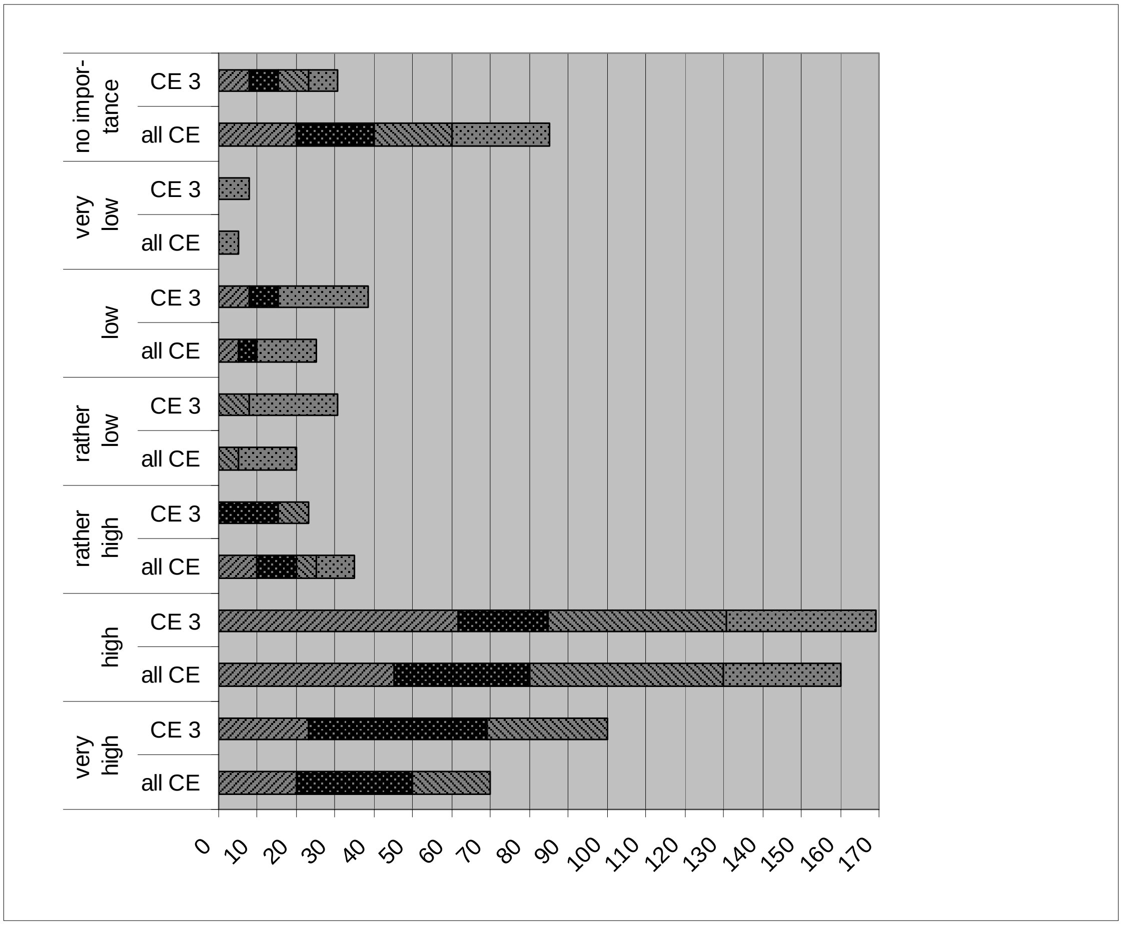


FIGURE 10: CONNECTION BETWEEN PET AND THE TIMING OF A TRANSFER

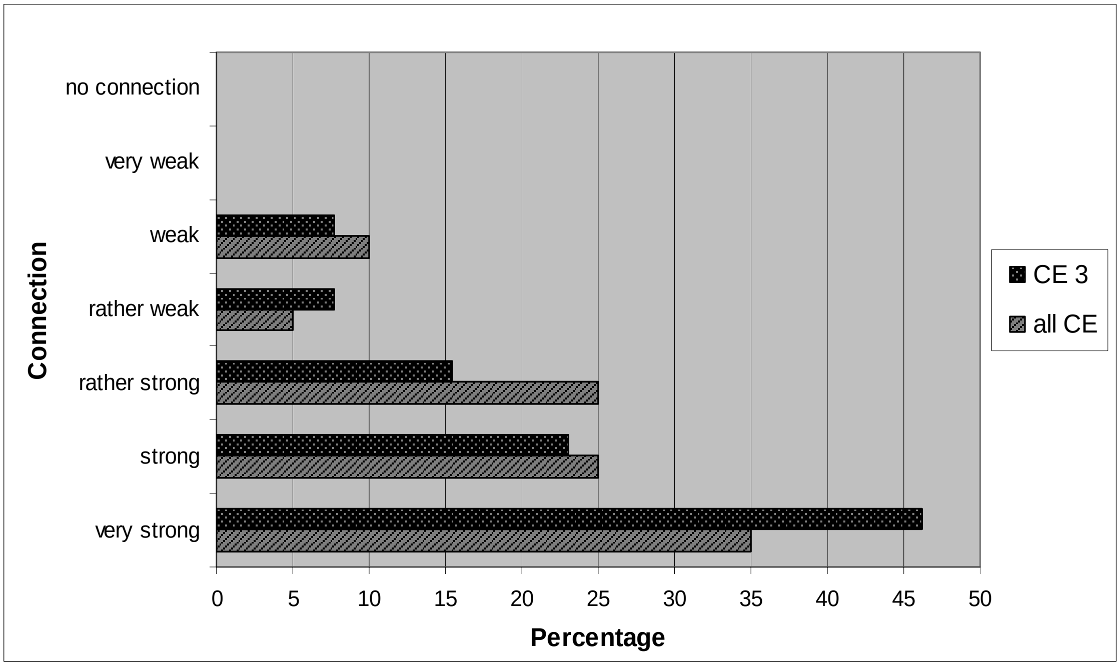
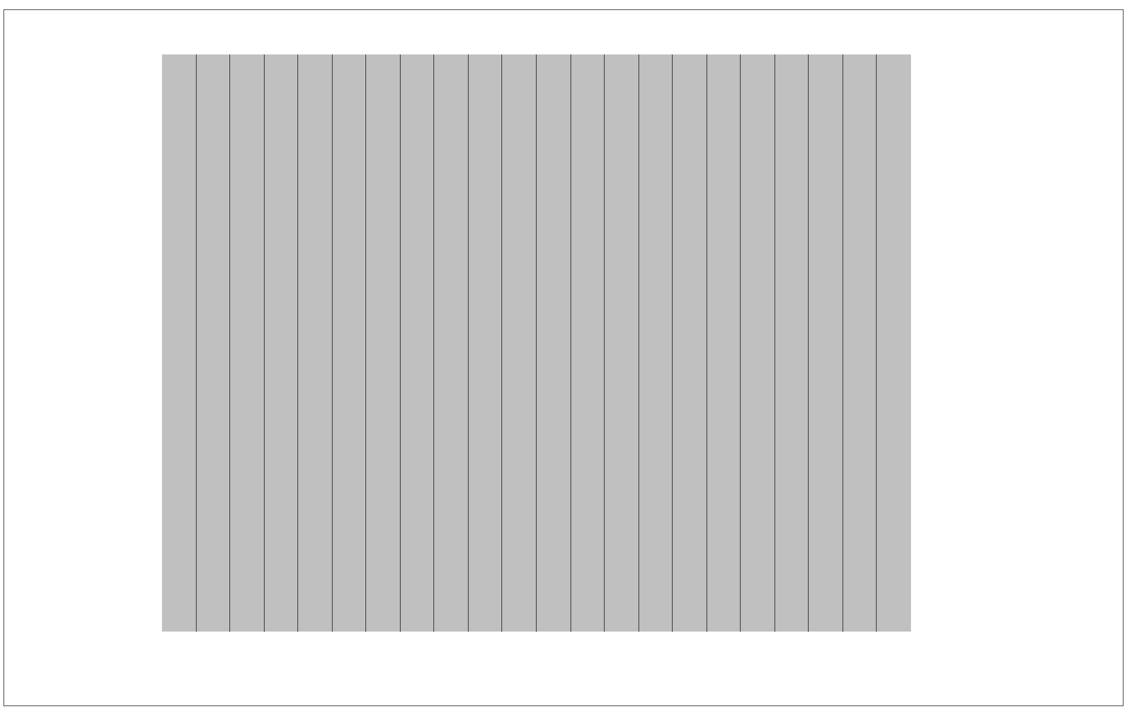


Figure 11 shows the evaluation of predetermined connections between PET and business succession. The level of agreement is used as standard of evaluation.

FIGURE 11: CONNECTIONS BETWEEN PET AND BUSINESS SUCCESSION



55% (61,5%) of the respondents fully or rather agree with the statement, that most business successions take place during lifetime as a result of PET. 15% (15,4%) explain that they are undetermined while 30% (23,1%) rather disagree or do not agree.

85% (84,6%) fully or rather agree with the statement, that most business successions taking place during lifetime are non-taxable because business property is transferred more than seven years before the death of the donor. 10% (7,7%) are undetermined and 5% (7,7%) rather disagree or do not agree.

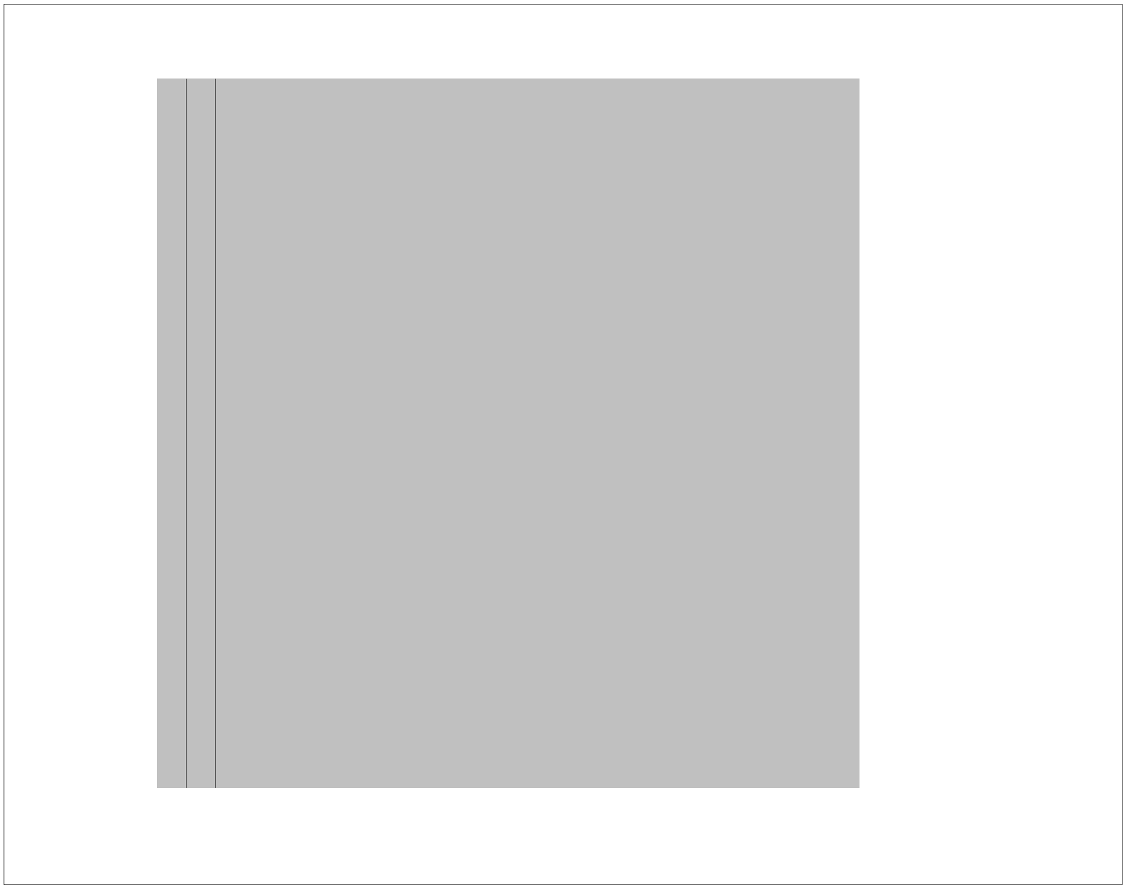
The statement, that most business successions become tax liable because the donor often is not still alive seven years after the transfer, is rather agreed by 10% (7,7%). 55% (61,5%) however rather disagree while 35% (30,8%) are undetermined.

5.3.2 Business Property Relief (BPR)

The Business Property Relief differentiates between a full- or a half-tax exemption for specified property. The tax exemption is achieved through the reduction of the transferred value. Figure 12 shows if there is a connection between this regulation and business succession. Connection here means the importance of this regulation for business succession within the family.

All of the interviewed tax pr

FIGURE 13: CONNECTIONS BETWEEN BPR AND BUSINESS SUCCESSION

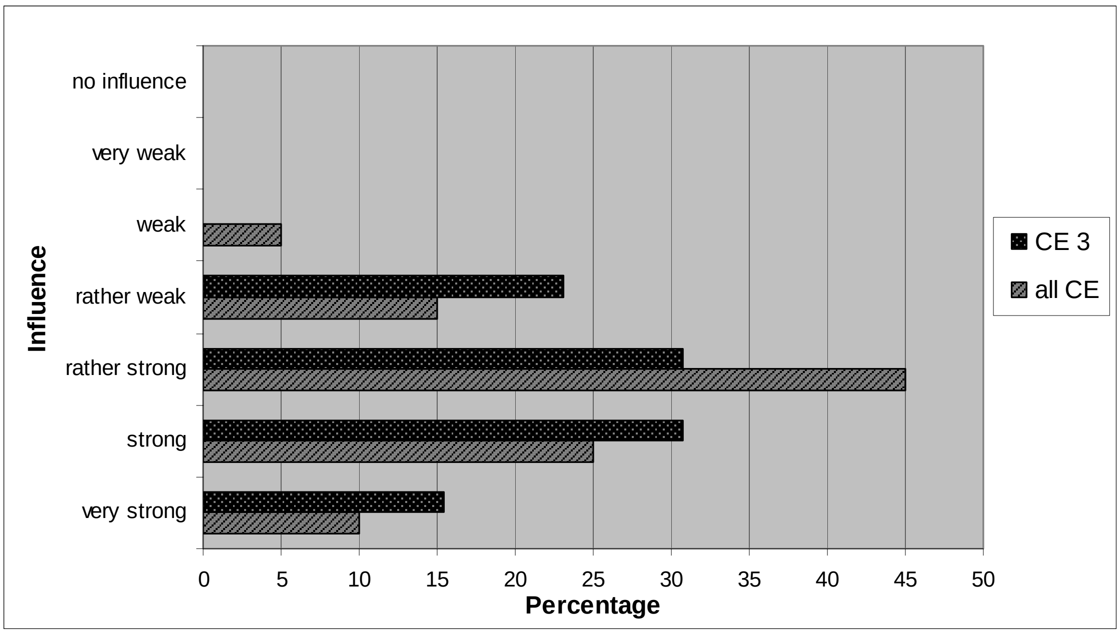


The level of tax exemption was evaluated as an important aspect by 95% (92,3%) of the interviewed tax professionals when planning the business succession within the family. The remaining 5% (7,7%) were undetermined, there was no disagreement.

5.3.3 Level of tax exemption of business property

The following figure shows the influence of the general level of tax exemption on business succession and the strength of this possible influence. "General level" means the division of business property into non-taxable or partially taxable (see BPR) and non-exempt (exempt property) business property. "Influence" means the importance of this differentiation for business succession within the family.

FIGURE 14: INFLUENCE OF LEVEL OF TAX EXEMPTION ON BUSINESS SUCCESSION



All respondents confirmed that the level of tax exemption influenced business succession. 80% (76,9%) evaluated this influence as "very strong", "strong" and "rather strong", and can be summarised as an overall strong influence.

Figure 15 shows the evaluation of the predetermined connections between the level of tax exemption (specific regulations) and business succession. The level of agreement is used as a standard of evaluation.

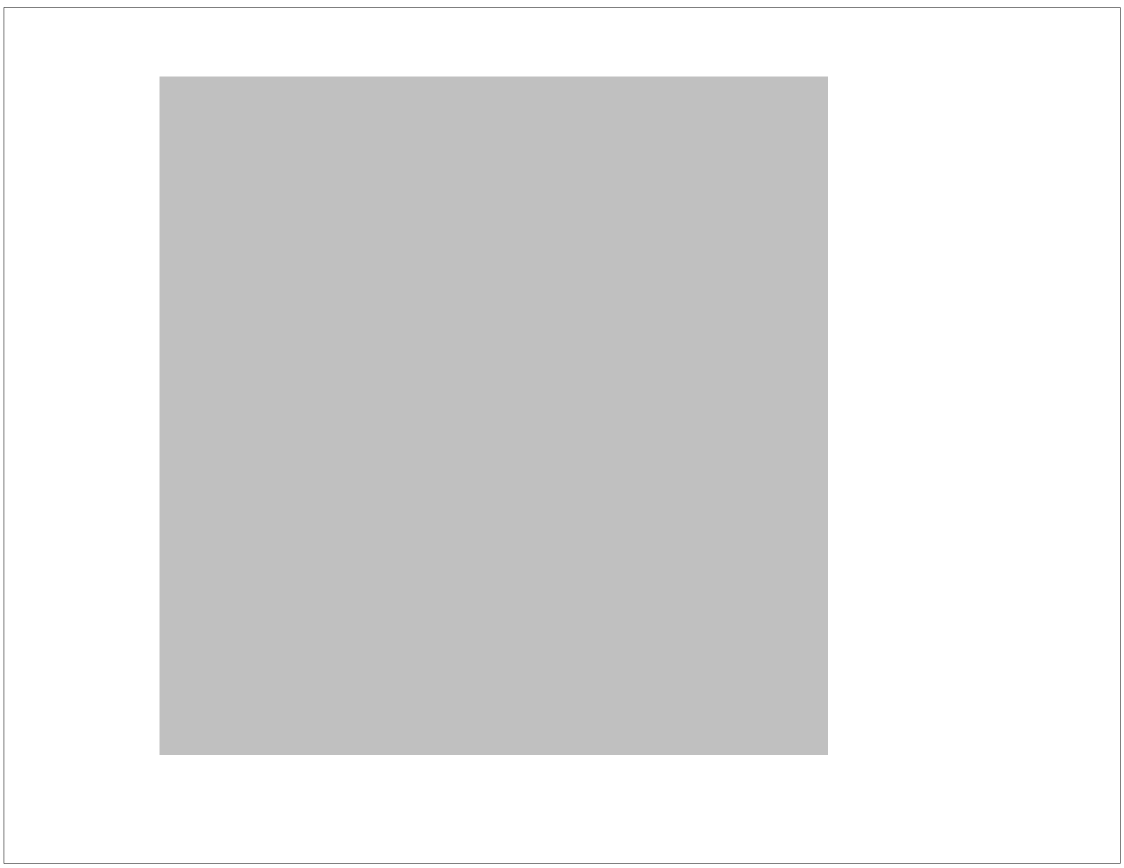
If the purpose of a transferred enterprise consists wholly or mainly in making or holding investments there is generally no tax exemption. But there is an exemption for holding companies, so that the BPR can be applicable. 55% (69,2%) of the respondents agreed fully or rather agreed to the statement, "this exception for holding companies facilitates the business succession of multi-level companies". 45% (30,8%) were undetermined, there was no disagreement.

Property that is not used entrepreneurial is generally evaluated as excepted property with no tax exemption. But if such property is planned for business purpose use in future, the BPR can be applicable. According to 50% (53,8%) of the interviewed tax professionals, this possibility facilitates business succession within the family. 35% (23,1%) were undetermined, while 15% (23,1%) did not agree.

The British preferential tax treatment of business property, (apart from in Germany), is not limited to domestic property. The statement, “that the possibility of considering also foreign assets as relevant business property facilitates business succession within the family”, was is fully or rather agreed by only 30% (30,8%) of the respondents. Most of the interviewed tax professionals, 65% (61,5%), of were undetermined and 5% (7,7%) did not agree.

The differentiation between business property that is available for a preferential tax treatment and business property that is taxed without an exception has to be done by using a so called wholly-or-mainly-test. This test has been developed because there is no fully legal definition that can be used to distinguish between non-exempt assets and assets that qualify for business relief. 55% (61,5%) of the participants have experience that this distinction is difficult, 10% (7,7%) are undetermined. According to 35% (30,8%) of the respondents, there is no difficulty distinguishing between non-exempt assets and assets that qualify for business relief.

FIGURE 15: CONNECTIONS BETWEEN THE LEVEL OF TAX EXEMPTION AND BUSINESS SUCCESSION



5.3.4 Restriction of Potentially Exempt Transfers

When the transfer of business property is treated as PET, the tax exemption (BPR) lapses retroactively if the property is sold within seven years after the transfer and the donor died after the sale and within these seven years. Figure 16 shows the existence and the strength of a possible influence of this restriction to the willingness of a potential successor to assume the business succession.

FIGURE 16: RESTRICTION AND WILLINGNESS TO ASSUME A BUSINESS SUCCESSION

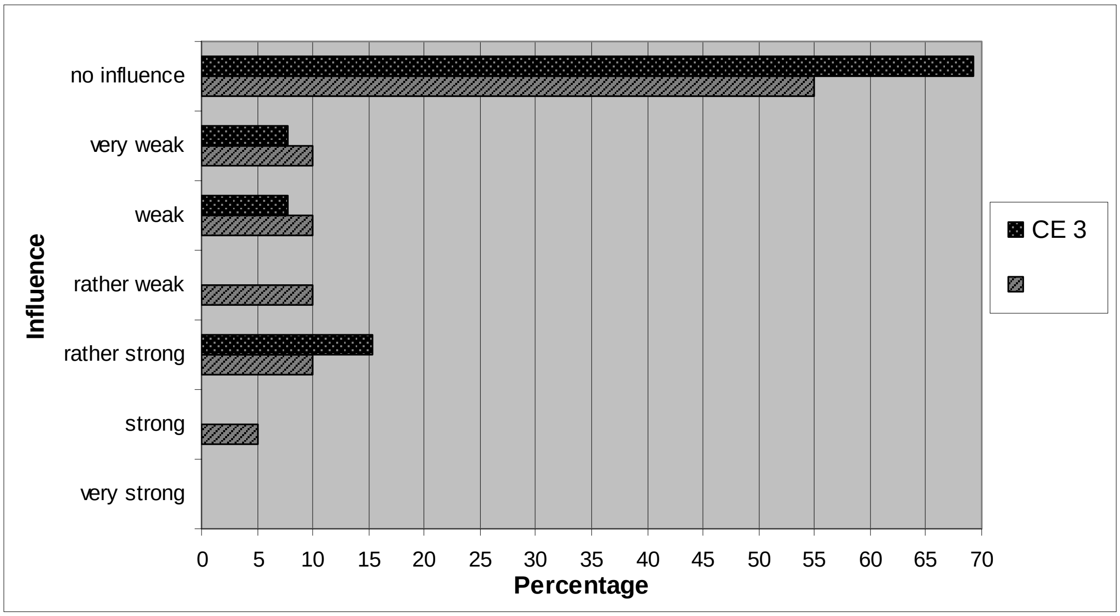


FIGURE 17: INFLUENCE OF THE LOSS OF TAX EXEMPTION TO THE CONTINUATION OF AN ENTERPRISE

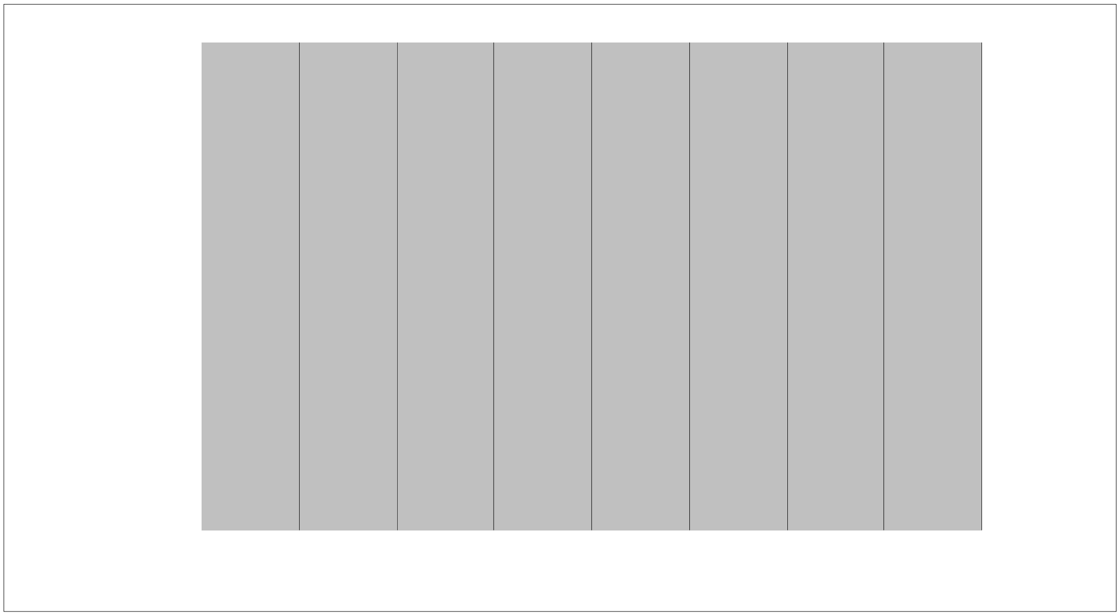


FIGURE 18: CONNECTIONS BETWEEN RESTRICTIONS OF PET AND BUSINESS SUCCESSION

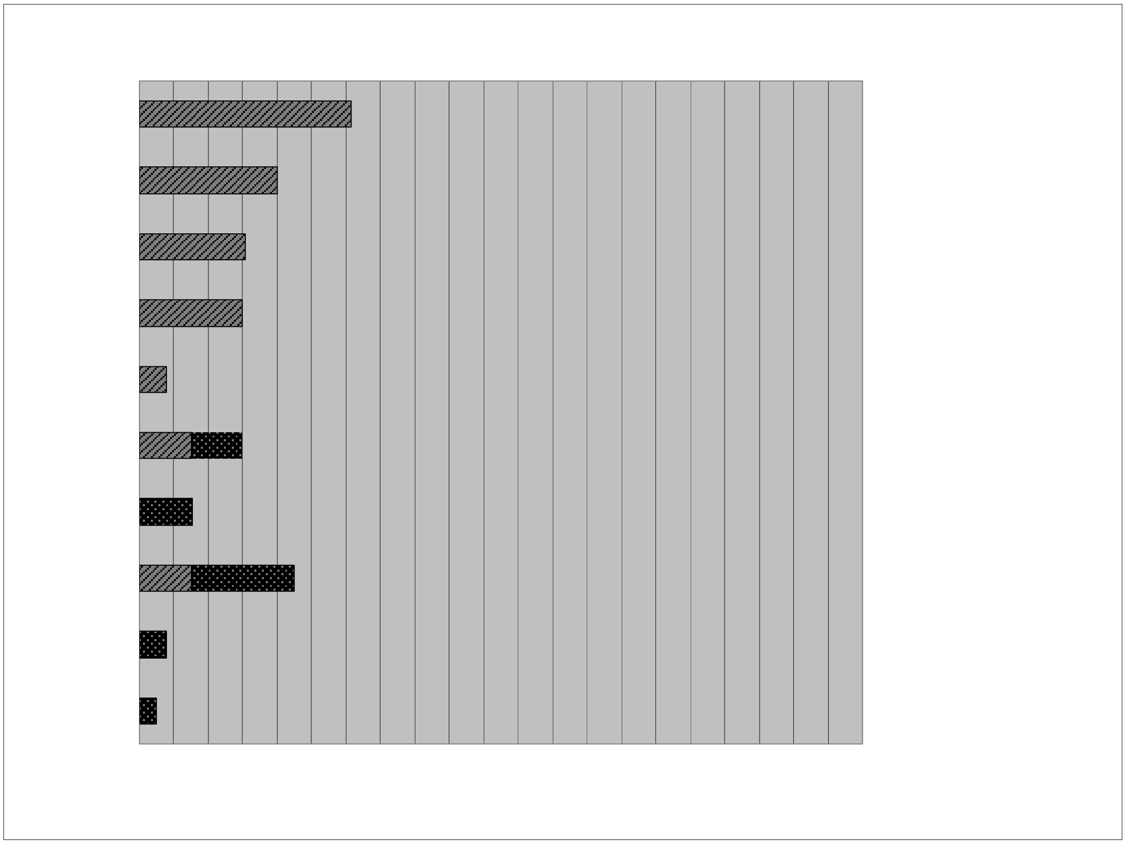


TABLE 2: EVALUATION OF THE EXPECTED EFFECTS

Expected effects	Confirmed	Partly confirmed	Not confirmed
The higher the liquidity burden due to taxation, the less probable is a business succession within the family.		X	
The higher the liquidity burden due to taxation, the less probable is the continuation of the enterprise within the family.	X		
The higher the level of the tax burden, the less the motivation for asset accumulation before the business succession.	X		
The taxation of business succession causes a composition of the transferred assets with the aim of the lowest possible tax burden.	X		
The higher the level of the tax burden, the more taxpayers move abroad to a country with lower taxes.			X
The potential tax exemption of lifetime transfers causes an early transfer of enterprise to the successors.	X		
The potential tax exemption of lifetime transfers ensures			

6.2 Methodological results

The results discussed in this paper are based on information of tax professionals who have participated in personal interviews.[77] To date the willingness of tax professionals

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