INTRODUCTION OF A NEW INHERITANCE AND GIFT TAX LAW IN GERMANY

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By the end of 2006, the German Inheritance and Gift Tax Law had been subject to a 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, a fact which resulted in an unequal tax burden. After more than three years of reform discussions, the German Parliament passed a new Inheritance and Gift Tax Law shortly before the former law would have lapsed on December 31, 2008, as the Federal Constitutional Court had requested the legislator to pass a reform by that date.

The new Inheritance and Gift Tax Law entered into force as of January 1, 2009. Some of the most notable changes relate to the valuation system which has been fundamentally amended. Furthermore, new rules allowing a preferential tax treatment for business assets have been introduced which initially included very strict requirements. However, certain changes to the new law have already been enacted as of January 1, 2010, but with retroactive effect for all cases governed by the new Inheritance and Gift Tax Law. These changes were particularly intended to ease the new requirements for obtaining a relief on the transfer of business assets, though the barriers for a preferential tax treatment remain high.

I. New Valuation Law

Under the new law, all assets have to be assessed at their fair market value. In principle, business assets are now assessed using a statutory standardised capitalised earnings value method. This method is generally based on the capitalisation of the

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average earnings of the business during the last three years preceding the transfer. At the taxpayer's discretion or if the standardised capitalized earnings value method leads to obviously inappropriate results, other industry-wide accepted valuation methods like the discounted cash flow method shall be applied. The new valuation rules will generally lead to significantly higher tax values as opposed to the situation before the reform, as formerly the value of business assets has largely been derived from the tax balance sheets. The application of the statutory standardised capitalized earnings value method may in many cases even generate an exaggerated business value.

Real estate is now assessed by different market valuation methods. Land is evaluated on the basis of a 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 capitalised earnings method. The necessary capitalisation factor depends on the remaining usage period. Nevertheless, the taxpayer has the possibility to prove a lower market value by presenting a valuation opinion.

According to the new law, agricultural and forestry property is evaluated using a modified capitalised earnings method that takes the specialities of this asset class into account. The basis for the calculation is the pure profit which has to be capitalised 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. Critics say that the application of these statutory valuation rules will in most cases still not generate the fair market price of the respective agricultural and forestry property. However, 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 the stock exchange value.

II. 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. The possibility of obtaining an extensive relief is particularly meant as a compensation for the higher tax values produced by the new valuation rules. However, since the Federal Constitutional Court had 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.

1. 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 % of the shares. However, minority shareholders have the possibility of pooling their shares to pass the 25 % test. A sufficient pooling agreement must include binding provisions which oblige the shareholders to exercise their voting rights unitarily and to uniformly dispose of the shares only. The latter criteria should be met where the pooling agreement sets out an unitary policy for the disposal of shares, e.g. a provision allowing a transfer without a duty to obtain consent only where the transferee is a close relative of the transferor or where the transferee is a pool member himself.

Business property located outside Germany 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 (EU-Member States, Island, Liechtenstein and Norway). 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.

Where business assets generally qualify for a preferential tax treatment, basic business property relief and an optional business property relief are available. According to the basic relief, 85 % of the business assets will not be part of the tax base whereas 15 % 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 % of the business assets will not be part of the tax base. Ideally, a business may therefore be transferred entirely free of German inheritance or gift tax.

However, business property may only benefit from the basic relief if it does not contain more than 50 % of so-called passive non-operative assets. Passive non-operative assets are, generally speaking, leased commercial property, minority shareholdings of 25 % or less, securities and cultural property. The optional relief is only available if the business property consists of no more than 10 % of non-operative assets. Where the 50 % and 10 % requirements respectively are satisfied, passive non-operative assets may benefit from the business property relief as well, but only if at the time of the transfer the respective assets have been part of the transferred business for two years.

Guidelines on the new law's application published by the German Tax Administration have confirmed that cash as well as savings accounts and fixed deposits do not qualify as non-operative assets for tax purposes. Therefore, the transfer of liquid assets without triggering inheritance or gift tax may be enabled where such assets belong to a business.

Moreover, a special focus should be placed on the fact that the threshold of 10 % for assets classified as non-operative for tax purposes only applies to the transferred entity, whereas the relevant threshold for subsidiaries at a lower level remains 50 %, even if the taxpayer opts for total exemption from inheritance or gift tax (optional relief). By executing respective reorganizations, it should frequently be possible to benefit from total exemption from inheritance or gift tax in order to transfer assets to the next generation.

The business property relief is intended to preserve the workplaces at the transferred businesses. Therefore, for basic relief the total sum of wages and salaries paid during the five years following the transfer must be at least 400 % of the historical average of the total wages during the last five years preceding the transfer. To benefit from optional relief, the total sum of wages and salaries after seven years must be 700 % of the historical average of the total wages. Where at the end of the applicable period the company's total sum of wages and salaries does not reach the relevant threshold, a corresponding percentage of the allowed tax deduction is lost.

Smaller businesses with 20 or fewer employees or an historical average of salaries and wages of € 0 are not subject to these rules. However, the tax administration intends to also apply the provision regarding the minimum sum of salaries to such parent or holding companies which have less than 20 employees, but whose subsidiaries have engaged 20 or more employees. Consequently, tax planning to avoid the application of the minimum sum of salaries provision by transferring shares to a holding company without any employees of its own may entail a considerable risk of litigation. There may still be an opportunity to avoid the application of the minimum sum of salaries provision resulting from the fact that only subsidiaries (including partnerships) with participations of a minimum of 25 % should be considered. Furthermore, employees of subsidiaries located in a state outside the European Union and the European Economic Area and the wages earned by these employees are disregarded for means of the application of the minimum sum of salaries provision.

Moreover, in order to benefit from the basic relief the transferee must hold on to the business assets for at least five years. On the event of a sale or abandonment of a business within five years after the transfer, the transferee partly loses the business property relief. In the case of optional relief the compulsory holding period is extended from five years to seven years. Several residuary clauses cover other events which have the same harmful effect as a sale or abandonment of the transferred business, e.g. the sale of essential assets or significant withdrawals. 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 business assets which do not qualify as non-operative. Where no exemption applies, the reduction of the business property relief depends on the time that has passed after the transfer up until the harmful event.

2. Real estate

The Federal Constitutional Court held that the concerns of the building and housing industry and especially the public interest in the availability of sufficient housing space 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.

Leased out real property which is part of a commercial business may be subject to the basic or the optional business property relief under the circumstances described above, provided that the principal purpose of the respective business is leasing out residential property. Under these conditions, such real property is not regarded as a passive non-operative asset for the 50 % and 10 % tests respectively. Privately held leased out residential property benefits from a 10 % 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 where the property is located in a state of the European Union or the European Economic Area. The transfer of the family home inter vivos between spouses and civil partners is free of tax if the family home is the family centre of the couple; a leisure residence or a second home will therefore not qualify for a tax-free transfer. The transfer of the family home to spouses, civil partners, as well as to descendants upon death is also free of tax, but generally only if the heir uses the family home for the following 10 years as his main residence. In case of a transfer upon death to descendants, a tax-free transfer is limited to a housing space of 200 square meters; any property exceeding this size limit may trigger inheritance tax.

Other real estate is not privileged. However, if the transferee could only afford to pay the taxes by selling the real estate, he is entitled to a general interest-free tax deferral.

III. 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 % to 30 %, depending on the value of the transfer received by each transferee. However, the tax rates have been changed for distantly related (siblings, nieces and nephews, aunts and uncles, etc.) and unrelated beneficiaries. The tax rates applicable to transfers to distantly related beneficiaries now range from 15 % to 43 % (before the reform: 12 % to 40 %). Very unfavourable are the tax rates applicable to transfers to unrelated persons, ranging from 30 % to 50 % (before the reform: 17 % to 50 %). An adoption may be an adequate means of tax planning to reduce the effective tax burden.

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 rate class for unrelated persons (30 % to 50 %). 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 in order to claim a personal allowance several times.

However, the named personal tax allowances only apply to cases in which either the transferor or the beneficiary are German residents because of having a permanent home or habitual abode in Germany. If neither the transferor nor the beneficiaries are residents, German inheritance and gift tax is due on transferred property situated in Germany only (for example, real estate and business property) and a personal tax allowance of € 2,000 only applies. The lack of a substantial personal tax allowance for non-residents means that a transfer of assets located in Germany between non-residents may trigger an extensive tax burden in Germany, particularly where business assets are transferred without meeting the requirements for obtaining a business property relief. Furthermore, this potential tax burden in Germany will generally not be avoided by the application of a tax treaty. Firstly, Germany has agreed on treaties on the avoidance of double taxation of inheritances and gift with very few countries (e.g. with the U.S., but not with the UK). Secondly, also under treaty law the contracting state in which business property or real estate is located usually does not give up its right to impose tax on the transfer of such property. Therefore, the new German rules on the taxation of inheritances and gifts may also give a reason for foreign owners of assets located in Germany to review the existing structure and reappraise a potential tax burden on the property's transfer.

IV. Conclusion

Under the new law, business and agricultural property as well as real estate may benefit from extensive reliefs. Ideally, such property may even be transferred entirely free of inheritance or gift tax. Nevertheless, it remains questionable whether the new regulations will provide an effective set of rules. In particular the new market valuation methods might not be practicable for tax purposes and are likely to trigger an increased number of valuation disputes. They also incur extra costs for the taxpayers as all transferred assets have to be valued at the fair market price. This will in many cases force the beneficiary to obtain a professional valuation opinion. At the same time, he must use tax structuring to minimize tax liability.

As the new valuation rules will in most cases generate a higher tax base than the rules applicable before the reform, the transferee and in case of gifts also the transferor must bear the risk that the transfer may trigger tax of a considerable amount, especially where business property relief may not be obtained. Therefore, fulfilling all conditions required to obtain a preferential tax treatment will frequently be mandatory to ensure the continuation of the transferred business, as the obligation to pay inheritance or gift tax on the full value of the respective business may be an unbearable burden. However, 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 extremely limits the flexibility of the successor, resulting in a restriction of business potential.

The new law also creates an exaggerated administrative effort. The tax authorities are obliged to monitor a transferred business for several years after the transfer to examine whether the transferee fulfils all conditions required to maintain the relief allowed to him. At the same time, taxpayers will frequently have no other choice than using advance tax structuring to minimize tax liability.

Finally, the new Inheritance and Gift Tax Law once again gives rise to questions concerning its constitutionality. This holds true particularly for the valuation of agricultural and forestry property and the taxation of real estate other than residential property. Several proceedings within the tax courts challenging the new rules have already been initiated. Ultimately, the Federal Constitutional Court may again have to decide about the compatibility of the German Inheritance and Gift Tax Regime with the Federal constitution.