Inheritance Tax Reform 2016
"Not all remains the same…"

The coalition's agreement of June 20, 2016 heralds the provisional end of a reform process that has lasted more than 18 months. The reform, pronounced a minimally invasive intervention, leaves many things unchanged related to the tax privileges for business assets, however, some amendments exceed the requirements of the German Federal Constitutional Court.

■ Almost unchanged: Relief models (*Verschonungsmodelle*)

There are two relief models for persons or companies subject to taxation on the transfer of business assets. The first is the standard exemption, according to which 85% of the value of the business assets is excluded and, in order to avoid subsequent taxation, the transferee must continue to operate the acquired business for five years (retention period) and maintain at least 80% of the business' payroll (jobs) (wage regulation). The second exemption option excludes 100% of the value of the business assets, but in this case the requirements are a retention period is seven years and maintenance of 100% of the business' payroll.

In contrast to previous options, the choice of one option or the other is now no longer dependent on the business assets consisting of only a certain quota of the assets that are excluded from preferential tax treatment (management assets). In the future, the person or company subject to taxation can choose freely between the two models.

In addition, there is a tightening of regulations for small businesses. While the wage regulation clause was previously not applicable from the outset to businesses with fewer than 20 employees, in the future, one must pay attention to the payroll regulation if one acquires a business with even six employees. However, when utilizing the standard exemption, the acquirer is only required to maintain 50% of the business' payroll if there are no more than 10 employees and only 60% if there are no more than 15 employees. In utilizing the second option for relief, the quota increases to 71%, respectively 81%.

■ As hitherto: Assets allowed preferential tax treatment

The provision for assets allowed preferential tax treatment also remains unchanged. This is still determined based on very formal criteria. All taxable business assets (thus also the commercial GmbH & Co. KG), as well as qualified shares in corporate enterprises (shareholding of more than 25% - alone or with others within the context of a pooling agreement) shall continue to remain eligible for preferential tax treatment. In order to clarify this point and in contrast to the first drafts

of the law, the agreement published today contains a reference to the fact that shareholdings in third party countries shall not be excluded from the outset from preferential tax treatment.

- **New: Management assets subject to taxation**

The question of whether inheritance tax relief can be considered will still be examined in the second stage. The so-called management assets must be separated from the taxable business assets. In contrast to former policy, in the future there shall be a fundamental tax liability for items of property that are part of the management assets. These shall be fully taxable at the regular rate, as far as the value of the management assets exceeds 10% of the total company assets (so-called "contamination clause" *(Schmutzklausel*). In an extreme case, if the management assets equal 90% of the value of the whole company, the remaining 10% of the tax-privileged assets is excluded from all relief in order to avoid any misuse.

- **New management assets / capital always taxable**

"New mangagement assets", i.e. those assets which were contributed to the business assets within a period of two years before the relevant transfer, are still completely excluded from any form of relief. In the future, "new capital" shall also be excluded from relief from the outset. This includes the balance from deposits and withdrawals from cash assets and other accounts receivable, which were brought in to the business within a time period of two years before the relevant transfer. The lawmakers are thereby trying to prevent persons or companies subject to taxation from maximizing and optimizing the allowable quotas for capital.

- **New: Consolidated appraisal of management assets**

The basic tax liability for management assets fulfills one of the essential requirements of the German Federal Constitutional Court. Consequently, this innovation also provided for a decisive change in the determination of the management assets. Until now, the management assets were determined separately for each company. In many cases, these could be omitted from the outset, because the management assets only became relevant, if they exceeded 50% of the value of the respective company. In operating companies this was almost never the case. In contrast, in the future, the management assets shall be calculated and summed up on a group company level. Thereby, in the future, the utilization of multi-level (cascade) company structures – as required by the German Federal Constitutional Court – will no longer be possible. The implications may be significant. While previously, for example, minority shareholdings of less than 25% and individual real estate objects rented to third parties were always given fully preferential tax treatment through the various corporate levels and did not usually affect the management asset quota of the company to be transferred, in the future, each item of property attributed to the management assets will be taken into consideration. This increases the complexity of valuation (individual valuation of each item of property of the management assets) and the possibility of legal disputes.

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Only minimal amendments: Cataloging of the management assets

The property items included in the management assets shall be determined on the basis of an almost completely unchanged catalog. This essentially includes real estate rented to third parties, shareholdings in corporations of less than 25%, as well as art and precious metals. Cash reserves and other accounts receivable are only considered part of the management assets as far as their value, minus all reserves and accounts payable, exceeds 15% (formerly 20%) of the total company value (so-called capital test). While the capital test allows for unlimited deductions of the company's debts from cash assets and other accounts receivable, for the management assets this only applies to a quota that is proportional to the value of the management assets in relation to the total company value.

The counter-exceptions to the qualification as management assets for real estate that are rented to third parties, but used for the purposes of marketing the company's own products (e.g. brewery restaurants and gas stations). In addition, it is clarified that the coverage assets for the company pension plan are not calculated as management assets. An additional counter-exception is real estate properties rented to third parties that are held in a so-called cooperative building company. As a rule, this includes real estate belonging to the taxable business assets, if the number of apartment units exceeds 300.

Additional relief in cases of succession: investment / interest-free deferral

If the value of the management assets exceeds 10% of the company value, in future inheritance cases there is at least the possibility of selling the management assets and investing them in business assets with preferential tax treatment; this must be done within one year after succession in order to avoid taxation of the management assets.

In addition, the heir may defer taxes due on the assets with preferential tax treatment – unconditionally and interest-free – for ten years after succession. This may also provide significant relief, which will have even more effect with increasing inflation.

Tightening up for large fortunes: ablation model…

In contrast to previous standards, relief can no longer be claimed independently from the value of the acquired business assets. Thereby, this agreement complies with the requirements of the German Federal Constitutional Court to limit the extent of relief for large fortunes. According to the so-called ablation model, the extent of relief is reduced by 1% of each EUR 750,000 in company value, if the value of the total business assets exceeds EUR 26 M. The result is that there is no longer any relief for acquirers of approx. EUR 90 M. Ultimately, the regulation invites division among transferees, in order remain below the limit of EUR 26 M per acquisition. Thereby, one must take

into consideration that the value of acquisitions is totaled within a ten year period. It is also noteworthy that a request for the application of the ablation model excludes the following application of the examination of the need for relief.

■ … or examination of need for relief (*Verschonungsbedarfsprüfung*)

The German Federal Constitutional Court did not, however, require a general abolition of tax relief for large fortunes. Rather, it takes the view that relief for large fortunes can only then justified if, based on a separate examination of the performance, it is determined that the accrued taxes could only be paid out of or by selling the business assets that have preferential tax treatment. The law takes these court requirements into account by implementing the so-called examination of the need for relief. The agreement focuses on the acquirer as a person and examines his assets. Out of his assets, the acquirer is required to lay out up to 50% of the taxes due on the acquired business assets. If 50% is not sufficient, an exemption from inheritance tax will be considered upon request.

The acquirer is not required to utilize the business assets that already receive privileged tax treatment. On the other hand, the acquirer must also utilize 50% of any gifts and inheritance that he receives within a period of ten years after claiming tax relief according to the examination of the need for relief. The quota of 50% appears to be significantly too high and is apparently solely based on political motivations. If the acquirer is required, for example, to sell taxed management assets in order to pay the required taxes, the quota quickly rises to 80% and more. In some exceptional cases, the quota can exceed 100% so that the acquirer, e.g., upon receiving subsequent gifts, is less financially secure than before receipt of the gift.

■ Special tax relief for family companies

Finally, another noteworthy point is the establishment of an advance deduction for family companies whose articles of association contain clauses typical for such family companies. The agreement initially refers to a limitation on disposal, according to which a transfer without consent may only be made to co-shareholders or descendants. In addition, the articles of association must provide for a limitation on distributions or withdrawals, according to which a portion of the profits must be ploughed back into the reserves. Finally, there is a requirement for a limitation on severance payments to shareholders who resign. The extent of the previous limitation is also decisive for the extent of the advance deduction. If a value of a maximum of 70% of the market value is taken as a basis for the severance payment, the full deduction of 30% is allowed. If a larger percentage of the market value is allowed as severance, the deduction decreases accordingly. The new special relief is a significant alleviation for family companies. However, it is only applicable if the provisions in the articles of association were already incorporated two years before the relevant transfer and if these are not revoked for 20 years thereafter. Thereby, it is highly recommended that family companies examine their articles of association and incorporate the appropriate clauses as soon as possible, if they are not already in place.