

## The New German Inheritance and Gift Tax Act

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# FEATURED PERSPECTIVES

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**I**t was a close call, but eventually the German legislative body managed to save the Inheritance and Gift Tax Act (Erbschafts- und Schenkungssteuergesetz) from being automatically abolished. In fact, abolishing the inheritance tax is not an uncommon measure in Central Europe. As of August 1, 2008, Austria no longer enforces inheritance tax, because the Austrian government did not comply with guidelines of the Austrian Constitutional Court (Verwaltungsgerichtshof), which set a deadline to remove the deemed unconstitutionality of the inheritance tax base.

Across the border, the German Constitutional Court (Bundesverfassungsgericht) found on November 7, 2006, that the German inheritance and gift tax, in particular the valuation of assets, is unconstitutional and had to be rendered constitutional by the German legislative body by December 31, 2008. The court demanded that all types of assets must be valued with their current market value for inheritance and gift tax purposes. Under the old regime, the transfer of business assets, assets related to agriculture and forestry, and real estate was much more favorable than the transfer of cash or stocks, due to lower valuations on the one side and special allowances on the other.

Going the Austrian way of abolishment was never seriously discussed, because the German states, which are the beneficiaries of the inheritance and gift tax, were not willing to lose approximately €4 billion in tax revenue. More important was the notion that the inheritance and gift tax must be upheld for social reasons because it fulfills some wealth reallocation purposes.

After a long debate in politics and public, the Bundesrat (upper house of the German parliament) passed the reform act (Gesetz zur Reform des Erbschaftsteuer- und Bewertungsrechts) on December 5, 2008, which entered into force on January 1, 2009. However, there is an option to apply the new regime (except for the personal allowances) for all cases of succession after January 1, 2007. The major changes are:

- new valuation rules for business assets, agriculture and forestry assets, stocks, and real estate;
- broader general personal allowances;
- a partial tax exemption for the transfer of a company; and
- tax exemption for owner-occupied real estate.

### Scope of Application

The reform has a major impact on all future inheritance and gift cases related to Germany or German citizens. The Inheritance and Gift Tax Act applies if either the deceased/donor or the heir/donee is:

- an individual with a domicile or a habitual residence in Germany;
- a German citizen who has been staying abroad for no longer than five years;
- a German citizen who lives abroad and is paid by the German government; or
- a corporation, association, or estate with a place of management or a registered office in Germany.

**Table 1. Personal Allowances**

| Tax Bracket | Persons  | Allowance Until December 31, 2008 | Allowance From January 1, 2009 |
|-------------|--|-----------------------------------|--------------------------------|
| I           | Spouses  | €307,000                          | €500,000                       |
|             | (Step) Children and their offspring  | €205,000                          | €400,000                       |
|             | Grandchildren  | €51,200                           | €200,000                       |
|             | Parents and grandparents (in case of succession)   | €51,200                           | €100,000                       |
| II          | Parents and grandparents (in case of donations), siblings, nieces and nephews, stepparents, parents-in-law, divorced spouses | €10,300                           | €20,000                        |
| III         | All other heirs/donees (for example, uncles, aunts); special purpose contributions   | €5,200                            | €20,000                        |
| III         | Same-sex partners in case of a registered partnership  | €5,200                            | €500,000                       |

In a cross-border inheritance or gift case, any double taxation can only be eased by unilateral measures or special double tax conventions. However, in the field of inheritance and gift tax, Germany has only concluded double tax conventions with Switzerland, the United States, Sweden, Greece, and Denmark. Yet the conventions with Switzerland and Greece do not cover any gift tax issues. In addition, Germany had concluded an inheritance tax convention with Austria, which was terminated effective January 1, 2008, because Austria abolished its Inheritance Tax Act.

**New Valuation Rules**

The German Constitutional Court was mainly concerned with differences in valuation between the various types of assets.

**Business Assets**

If possible, the current market value is determined according to the sale of assets within one year before the point of taxation. If there were no sales, the current market value is estimated by taking into account the future profits. Thus, the substance value (sum of the current market value of the single assets minus liabilities) constitutes the minimum value for the purpose of taxation.

**Agriculture and Forestry Assets**

The current market value is determined on the basis of future profits.

**Stocks**

The stock market price is used for tax base purposes. If that price is not available, the price is determined according to the approach used for business assets described above.

**Real Estate**

The current market value depends on the type of property. Either the comparative value method, the profit method, or the property value method applies.

**Other Assets**

The current market value is used for movable physical assets, the par value for receivables and similar assets, or the capital value for recurring payments.

**New Allowances and Tax Rates**

As Table 1 shows, the personal allowances have been elevated in all tax brackets.

Moreover, as Table 2 shows, the tax rates that are directly linked to the tax brackets were changed.

**Exemption for Owner-Occupied Homes**

Before the reform, there was a tax exemption for owner-occupied real estate if the property was transferred to a spouse. The new rules extend this exemption to cases of succession, applying not only to spouses but also to life partners of a registered partnership. This requires that the real estate is personally used for living purposes for 10 years after the transfer. The exemption also applies to a transfer to a child (or, if deceased, to a grandchild) unless the real estate is larger than 200 square meters.

However, if the real estate is sold within the 10-year period, the tax exemption will be eliminated retrospectively, unless there are compelling reasons for the sale, such as death or need of care.

**Exemption for Business Assets**

A highly disputed issue in the course of the legislative process was the treatment of business assets for inheritance tax purposes. The goal was to ensure that

**Table 2. Tax Rates**

| Value of the Taxable Assets up to |                      | Tax Rate Until December 31, 2008/From January 1, 2009 (%) |            |             |
|-----------------------------------|----------------------|---|------------|-------------|
| Until December 31, 2008           | From January 1, 2009 | Bracket I   | Bracket II | Bracket III |
| €52,000                           | €75,000              | 7/7   | 12/30      | 17/30       |
| €256,000                          | €300,000             | 11/11   | 17/30      | 23/30       |
| €512,000                          | €600,000             | 15/15   | 22/30      | 29/30       |
| €5,113,000                        | €6,000,000           | 19/19   | 27/30      | 35/30       |
| €12,783,000                       | €13,000,000          | 23/23   | 32/50      | 41/50       |
| €25,565,000                       | €26,000,000          | 27/27   | 37/50      | 47/50       |
| above<br>€25,565,000              | above<br>€26,000,000 | 30/30   | 40/50      | 50/50       |

business owners contribute their share to the budget without creating a lack of liquidity, or bankruptcy, either on the level of the companies or on the level of their new owners.

Under the new exemption rule, an heir of a company must bindingly choose one of two options:

- *Option 1:* If the heir of the company continues the core operation of the company for seven years, 85 percent of the transferred business assets are tax exempt. This requires that the sum of salaries after seven years is lower than 650 percent of the sum of salaries at the time of succession. Moreover, the share of administrative assets compared to the total business assets must not be higher than 50 percent.

- *Option 2:* If the heir of the company continues the core operation of the company for 10 years, 100 percent of the transferred business assets are tax exempt, if the sum of salaries after 10 years does not exceed 1,000 percent of the sum of salaries at the time of succession and the share of administrative assets compared to the total business assets is not higher than 50 percent.

After all, one of the most prestigious and prominent tasks of the government in this legislative period has found its way to the tax code. The new rules bring much legal certainty for heirs of businesses, even though some questions regarding the sum of salaries and the holding period remain. ◆