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Arbitration Committee agrees on Inheritance and Gift Tax Reform: Key Points.

The Members of the Arbitration Committee of the Federal Parliament (Bundestag) and the Federal Assembly (Bundesrat) have reached a compromise on the inheritance and gift tax reform after a seven hour session going on late into the night. Here is a summary of the key points.

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A draft bill for the amendment of the Inheritance and Gift tax Act follow a decision of the German Constitutional Court in January 2015 has been in existence since 2015. On 24 June 2016 the Federal Parliament finally voted for the amendment after a long political process, only for the bill to be defeated in the Bundesrat, which called for the establishment of an arbitration committee. This committee has now arrived at a compromise, which must be confirmed by both the Bundestag and the Bundesrat. Here a summary:

Valuation Reduction for Family Businesses

Many family businesses are subject to restrictions under the terms of the entity's statutes whether it be in relation to drawing profits, transferring the business interest or exiting the business. The new bill provides for a valuation reduction of up to 30%. According to the compromise, this valuation reduction will be applied to specific favoured assets and not to the fair market value of the relevant holding. Furthermore the relevant restriction must have been included in the entity's statute two years before the succession/gift and must continue 20 years thereafter. In addition the entity's statute must contain the provisions, which:

- Limit the drawings or distributions to a maximum of 37.5% of the profit for tax purposes after deduction of the income tax attributable to the relevant profit share or distribution. Drawings made to cover the income tax due on the profit share/distribution are not included in the restriction of the drawing/distribution.
- Restrict the power to dispose over an interest in the partnership or corporation to members of the entity, to relations or to family trusts.
- Provide that any compensation paid in the case of a withdrawal from the entity by a member is lower than the fair market value of the interest in the partnership or company.

Finally, the provisions must reflect the actual circumstances.

Adjustments to Valuations

The draft bill voted in by the Bundestag assumed that there would be an amendment to the Valuation Act. The basis interest rates foreseen therein - as at 31 December 2015 - would have resulted in a capitalisation factor for 2016 of between 10 and 12.5 (where it had previously been 17.86). The Bundesrat was concerned that this could mean that, taken with the valuation reduction for family businesses, the value of the transferred interest for tax purposes could be more than 50% lower than the fair market value of that interest. A compromise was reached by the committee so that the capitalisation factor will be fixed at 13.75. This should be achieved by allowing the Federal Ministry of Finance to adjust the capitalisation factor in line with the interest rate structure.

Special Allowance for Property Transfers

According to the Constitutional Court, any special allowance for large property transfers must be specifically

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justifiable. According to the new rules, transfers of property in excess of a value of 26 million Euro may benefit from two alternative models. The so-called dwindling model provides for a declining basis treatment, according to which the deduction applied to large transfers will be gradually reduced by one percentage point for each 750,000 Euro the transfer exceeds 26 million Euro. The draft bill of the Bundestag does not provide for a basic allowance, so that the benefit may be reduced to nil. The Bundesrat had originally demanded a straight reduction and no allowance for transfers below 90 million Euro. According to the compromise, the draft bill has been accepted in this regard.

20 Per Cent Quota for full tax exemption

According to the compromise, the condition for the granting of an optional allowance, which is provided for in the current law, should also be included in the new law. However, a 20 per cent quota has been agreed upon. This means that the tax exemption will only be granted if less than 20% of the favoured property comprises so-called “management property” (such as, e.g., real property leased to third parties, shareholdings of 25% or less, works of art). The ratio of management property to business property is calculated on the basis of the fair market value of the management property in comparison to the fair market value of the business as a whole.

Financing Test

The basic allowance for financing in an amount of 15% of the fair market value of the business asset acquired will in future only be available, if the favoured asset is used mainly in a land and forestry business, a trade or profession or if it is a holding company. Furthermore, the previous administrative practice of applying the financing allowance to both assets held in common and special business assets in the case of trading partnerships will now become law.

Extension of the management property catalogue

An essential part of the original 2015 draft bill was the new definition of “favoured assets”. This “U-turn” has now been abandoned. The previous system of a negative catalogue remains in place, according to which “harmful” assets are listed, so that “favoured assets” and “harmful assets” are differentiated from each other. The Bundesrat wanted to exclude from the benefit interests in deemed commercial partnerships and similar corporations, because it could mean that private assets could be transferred in a preferential manner. The compromise provides that the preferential treatment will not be available on leisure or luxury assets - such as works of art, art collections, coins, precious metals and stones or other assets which are typically connected to an individual’s lifestyle - unless the trading, processing or leasing of these assets constitute the main purpose of the business.

Keywords

Inheritance and Gift Tax Reform 2016, Private Wealth, inheritance and gift tax