EFB response

to consultation on possible approaches to tackling cross-border inheritance tax obstacles within the EU

EUROPEAN FAMILY BUSINESSES

The position of EFB on gift and inheritance tax.

Importance of taxation for family businesses

Fiscal issues related to family businesses are of key importance to both family businesses and society at large. This is due to, firstly, the major importance of family businesses in terms of fostering and creating new jobs, giving rise to tax revenues, cherishing renewal and innovation, as well as contributing to sustainable development. Secondly, there are several tax issues that are characteristic of family businesses and particularly affect them.

For family businesses, **taxation has three dimensions**: business, current owners and future owners. Currently, in most European countries income from equity is subject to at least partial or even full double taxation: firstly, profit generated in the business is taxed at the applicable business tax rate. Secondly, the profit distributed by the business to its owners is taxed at owner level. Thirdly, when passed from one generation to another the business assets are often further taxed. In many cases this two-fold or even three-fold taxation causes the total tax burden of family businesses and their owners to be higher than the total tax burden of businesses held by other types of owners.

Long-term ownership and stewardship typical of family businesses encompass the goal of **transferring the family business** to the coming generations rather than selling it. Hence, a share in family business is not regarded as a transferable asset but rather as an asset to be preserved, developed and passed on. Where transfers of business within the family through gifts or inheritance trigger tax consequences, these taxes actually inflict an economic burden on the business.

Taxes on transfers of family business are taxes on enterprises

The problem with gift and inheritance taxes due on family business assets is that these reduce the ability of the business to grow, create employment and invest. More often than not assets have to be extracted from the business in order for the gift recipient or heir to be able to pay the due taxes. Regardless of whether such funds are provided by the business in the form of a loan or a dividend, they weaken the ability of the business to grow and invest. As a further burden on the business, the extraction of funds decreases the possibility of the business to acquire debt finance, i.e. limits its access to finance. At the recipient end any retained earnings extracted from the business in the form of dividend, triggers capital income tax and represents a second layer of tax on the gift or inheritance.

The detrimental effects of the extraction of assets from businesses due to taxes on the transfer of business have been considered by the EU Commission (see EU Commission Communication on the Transfer of Business, 14 March 2006): Where **inheritance taxes extract liquidity and assets from businesses**, their short-term tax revenues might be more than outbalanced by long-term revenue losses resulting from the discontinuation of businesses. Therefore, the relief from various taxes on the transfer of family business is beneficial from the state tax revenue perspective as well.

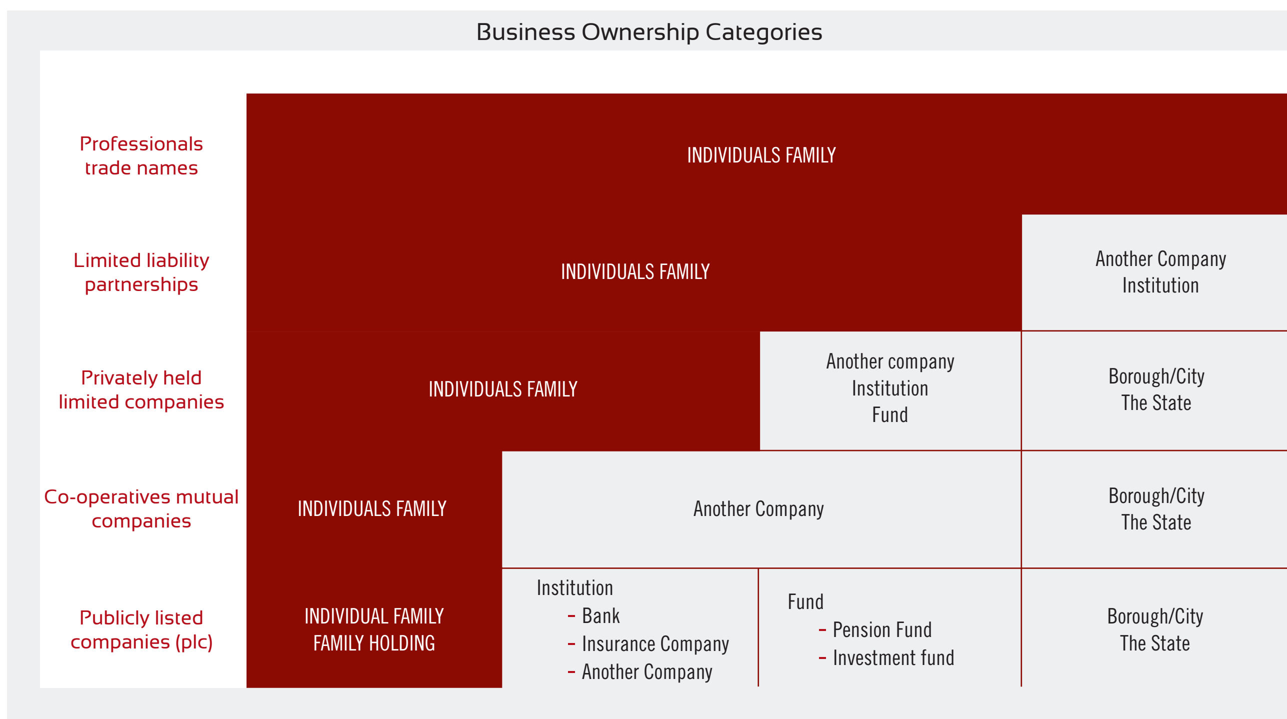
Tax neutrality between different kinds of owners

As a combination of the above-mentioned points, EFB desires a **tax system that treats the owners of family businesses equally** in comparison to other kinds of owners. The comparison should be made on a three-dimensional basis (business - current owner - future owner) and not separately at business or owner level as often is the case. Of all types of companies only businesses held by households face recurring taxes on the basis of their assets, while companies held by owners of a more perpetual nature (e.g. foundations, institutional investors, co-operatives, states or municipalities), face no such taxation. This provides non-family businesses with an unfair competitive advantage in their ability to accumulate capital.

Intra-family change in legal ownership rather envisages a change in the representative (the family member) of the owner (the family) than a true change of ownership. Therefore, EFB considers that intra-family transfers of business should not be regarded as taxable events with regard to gift and inheritance tax, capital gains tax, transfer tax or similar other taxes on the transfer of a share in business. This would enable the families to plan and execute intergenerational transfers of business free from the otherwise strongly steering and burdensome factor of taxation.

It would obviously be complicated to reform various civil law systems to reflect the principle that intra-family transfers of business are not regarded as a change of ownership in terms of law. However, it could often be a feasible solution to regard an **intra-family transfer of business as a non-taxable event** even though it represents a change of ownership in terms of civil law. This solution should apply to all of the above-mentioned various forms of taxes on the transfer of business regardless of whether they are gratuitous or not. Currently, measures exempting a transfer of business within a family from tax, independent of the technique applied, exist in several countries, e.g. the UK (exemption from inheritance tax) and Finland (exemption from capital gains tax).

To illustrate the importance of this issue, the enclosed diagram may be useful. It depicts in broad terms the proportion of company equity held by different types of owners. The dark maroon fields represent company equity that is subject to gift and inheritance tax, while the white fields represent company equity that is held by owners immune to death or succession and hence is never subject to inheritance or gift tax.



EFB welcomes the development of abolishing or relieving taxation on transfers of business that has taken place in several EU member states in previous years, as referred to in the study published by the Commission in relation to the consultation at hand. These changes mitigate the current disadvantages to business ownership by physical persons.

Finally, be it equity or debt, business assets or speculative investment assets, or the aim of long-term holding or short-term disposal of assets, the tax system should be neutral towards them all. It should create a level playing field for all forms of savings and all types of owners.

Cross-border inheritance and gift tax obstacles within the EU

Impact of inheritance tax on family businesses in a cross-border context

EFB considers that attention should be paid to cross-border inheritance and gift tax obstacles and they should be effectively tackled. It is clear that international double taxation may be an obstacle to cross-border activity and investment within the European Union.

As mentioned above, inheritance and gift tax poses several challenges to family businesses at a national level. Subsequently, when double or even more-fold taxation occurs in cross-border inheritance or gift situations, the negative implications of taxes on family businesses may grow substantially larger than in a purely national context. This would lead to a growing need to extract funds from the business in order to be able to pay the inheritance or gift taxes due in several countries. This, again, would lead to funds flowing out of business activity and hence have a negative impact on the ability of businesses to pursue growth by employing people and investing in the business. It would limit the will and possibilities of the businesses and their owners to move and operate cross-border within the Internal Market.

One additional issue related to inheritance and gift tax on especially transfers of business should be concerned. In several member states, there are inheritance and gift tax reliefs related to business transfers at the national legislative level.

In a case where the deceased and the heir are both residents in member state A, inheritance tax is often relieved as far as assets related to a business are concerned. If e.g. the deceased lives in member state A and the heir in member state B, member state A would still often grant the relief on inheritance tax.

However, if member state B in the above-mentioned case does not grant a relief on the business related assets at all or the relief is smaller, state B could impose full inheritance tax. If state B applies the ordinary credit method in its domestic legislation, state B would allow a credit for the inheritance tax levied by member state A. However, should member state A have applied a relief, the credit granted by member state B could be minimal. Hence, the result could be that even though member state A has granted a relief on inheritance tax in the purpose of ensuring the continuance of the business, the total inheritance tax burden remains the same for the taxpayer as it would have been had member state A levied full inheritance tax.

To avoid above-mentioned problems concerning the mitigation of a national relief of inheritance tax on business transfers in cross-border situations, member states should be encouraged to apply the exemption method instead of the credit method as the domestic method for relieving double taxation in cross-border situations.

Methods of relieving double taxation

1. Completing a full network of bilateral double taxation treaties

In EFB's view, this would be a comprehensive and effective way of minimising double taxation on cross-border inheritances and gifts. On the other hand, bilateral double taxation treaties would be an effective tool for the member states in preventing arbitrary nil-taxation in a cross-border context.

However, a challenge related to building a full network bilateral double inheritance taxation treaties might be that it is rather time consuming to draft and negotiate completely new double tax treaties. As there are currently 33 out of 351 possible inheritance tax treaties in place between the member states, most of the member states would have to draft and negotiate up to 26 new treaties each. In relation to the share of inheritance tax of the annual tax revenue of the EU member states and, further, in relation to the amount of inheritance tax revenue attributable to cross-border situations, it could be considered rather time consuming by the member states to create a full network of bilateral double taxation treaties.

2. Including inheritance tax rules within the scope of bilateral income tax treaties

In comparison to alternative 1, including rules on inheritance tax in income tax treaties would be remarkably less time consuming than drafting completely new bilateral double tax treaties for inheritance tax. This would require some changes in the structure of the current double tax treaties on income and wealth and the inclusion of a few new legal terms as well as new articles in the treaties.

However, taking into account that bilateral double tax treaties are usually amended and reformed not more often than every 5 to 15 years, it could take probably a couple of decades before all the member states have included rules on inheritance tax in all of their bilateral income tax treaties. Regardless of the probably long period of time to achieve a desired level of bilateral double tax treaty rules on inheritance and gift tax, EFB considers that it would be important that the EU Commission would encourage the member states to start including rules on inheritance tax in their bilateral income tax treaties if not sooner then at least at a pace normal for negotiating and amending the contents of the current treaties.

3. Where domestic relief is not granted at all, adopting domestic mechanisms to eliminate double taxation in cross-border situations

As mentioned above, encouraging the member states to use the exemption method in order to relieve double taxation would be important to ensure the effectiveness of national reliefs on inheritance tax on business transfers in cross-border situations as well.

As a complementary measure to the above mentioned point 2, EFB considers that improving unilateral mechanisms for the elimination of double taxation in the national legislation of the member states would be an effective step in tackling the problems caused by double taxation. Amendments in national legislation can be made rapidly and they can be directed effectively at the issue at hand. This would give time for introducing the bilateral elimination of double taxation by applying alternative point 2. It would also be a quick and efficient way of reducing obstacles to cross-border activity and investment within the European Union posed by inheritance and gift tax.

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European Family Businesses is a federation of 11 national family businesses associations. Our aim is to make political decision makers aware of the contribution of family businesses to society at large and to promote policies that are conductive to long term entrepreneurship. Our members represent turnover in excess of one trillion Euro, 9% of European GDP.