

Special Section

The Constitutional Court's Inheritance Tax Case

A Decision on Inheritance Tax by the German Constitutional Court: A Brief Comment

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Abstract

In Germany, endowments and bequeathals are subject to between seven and fifty percent inheritance tax. Small and medium-sized family-run businesses are exempt from inheritance tax either partially or entirely. On 17 December 2014, Germany's Constitutional Court ruled that the present system of enabling businesses to "avoid paying" inheritance tax was in violation of the "rule of equal tax principal." Furthermore, the inheritance tax law in its current form leaves plenty of leeway for variations in percentages of payments, which are difficult to justify. Thus, the Court ruled, existing laws are unconstitutional and must be reformed and replaced.

In this case note we argue from a socio-ethical viewpoint that inheritances taxes are in principle morally justified. One important key element of the tax system is trust. This trust can be strengthened by (1) creating sustainable laws that will stand the test of constitutional screening, (2) offering plausible justification for fiscal policies including exemptions on clear normative principles like subsidiarity, common good, freedom and simplicity, and (3) broadening the tax-paying basis without undercutting relevant human agency.

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A. Introduction

In Germany, endowments and bequeathals are subject to between seven and fifty percent inheritance tax as a result of legislation. The amount of tax due is calculated according to the actual value of the estate bequeathed and to the tax bracket applicable which in turn depends upon the degree of kinship. Properties valued at between €20,000 and €50,000 (the maximum for spouses) are exempt from inheritance tax as are additional security allowances amounting to €256,000 (for spouses). The annual tax revenue of approximately €4.5m is currently accrued by the *Länder*—German Federal States.

According to the legislative authorities, Germany's *Mittelstand*—small and medium-sized family-run businesses—are exempt from inheritance tax either partially or entirely. German legislation, thus, aims to protect and promote such family businesses for the German economy as a whole, because such businesses not only aim at their survival but also at securing the workplaces of the people in their employ. Such company structures are production procedures which receive world-wide acclaim. If restrictive legislation was introduced—as is planned for 2016—such businesses might run a serious risk of going broke.

B. The Inheritance Tax Case at the Federal Constitutional Court

The case was brought to the Fiscal Court claiming that the current regime was a violation of tax equality and on 17 December, 2014 Germany's Constitutional Court in Karlsruhe ruled (1 BvL 21/12) that the present system of enabling businesses to “avoid paying” inheritance tax by allowing the transfer of company ownership and assets to the next generation was in violation of the “rule of equal tax principal” (Article 3 Abs. 1 of the Basic Law) and disproportionately benefitted such medium-sized companies—to the disadvantage of private persons on the one hand and larger companies on the other. The inheritance tax law in its current form leaves plenty of leeway for variations in percentages of payments, which are difficult to justify. Thus, according to the ruling, existing laws are unconstitutional and must be reformed and replaced before the end of June 2016.

The debate has been framed by *The Economist* as a political discourse between business friendly and less business friendly parties. The main bone of contention in the fierce debate on reform has to do with the fact that:

- Small companies with fewer than twenty employees are exempt from tax, providing they can verify that workers remain in their employ for more than five years in succession. This results in an eighty-five percent part exemption. For employment lasting longer than seven years, the companies enjoy a one hundred percent exemption. The current system means that businesses with

more than twenty employees can “exploit” the system to their own advantage by splitting the company into sub-sections each with fewer than twenty workers;

- Companies can avail themselves of tax exemption if the percentage of administrative capital is less than fifty percent of total company assets. This is designed to avoid amassing “unproductive” capital such as third party disposal or utilization of unused land or estate, shares in corporations, investment shares, works of art and art collections including valuable coins, precious metals and stones etc., which are “wilfully” “relocated” to offset—or circumvent—taxes due. The constitutional court has decided that the fifty percent limit currently levelled is unjustifiably high and that a limit clearly below the fifty percent mark would be both advisable and beneficial.
- Both provisions are available and accessible to a wider range of company structures meaning that the catchment net for those seeking tax benefits vastly exceeds the intended confines and limits for small and medium-sized family-run companies and that companies with higher gains thus also unjustifiably enjoy the same tax benefits.

All in all, the Court concluded that the resulting discrimination stands in violation of the principle of performance and productivity security even though it accepted the concern of lawmakers to protect family-run companies when they are passed on to the next generation so that their future is not put in jeopardy from a fiscal perspective.

Three judges (Gaier, Masing and Baer) dissented from the Court’s ruling reached in the first sitting of the Senate, which decrees that the decision reached was untenable with Article 3, paragraph 1 of the Basic Law, by adding an interpretation of the unequal tax treatment in the light of the principle of social statehood. This assessment aims to give further weight to the decision and to fully reveal the aspects of social justice at stake by the given possibilities to influence tax liabilities. The margin of tax deviation must be considered within the context of the social state, as any attempt to bypass or evade regulations can only be implemented if they serve the economic goals for the public common good.

The aspect of the social state does additionally demand that any contingency be justified by some form of means-testing in striving to achieve tax equality and iron out discrepancies in safe-haven thinking:

Those who will profit most will be successful businesses with the largest assets and thus the most influence on the structure of the social state per se,

we will be protecting and supporting those who have invested neither personal effort nor capacity but inherited a profitable business purely on the grounds of kinship and personal relations; such practices can only promote and ingrain economic inequality (BVerfGE 1 BvL 21/12, translation by authors).

In section I. 5 BvL 21/12, the Federal Constitutional Court draws on the evaluation carried out by the Federal Ministry for Finance on inherited assets and estates and endowments bequeathed before death whereby 6 percent of all cases were examined. In ninety-four percent of cases examined, it was immediately apparent that there would be no tax burden (results based on figures collected 2010). In 2012, € 74.2billion in assets were bequeathed as outlined above and of this amount, fifty-four percent (€40.2billion), more than half, were bequeathed tax free in accordance with Sections 13a and 13b.

C. Socio-Ethical Considerations

Considering the above from a socio-ethical viewpoint, the following can be noted:

- 1) Small and medium-sized businesses are the backbone of the social economy in Germany today (Soellner 2011); protecting them serves the protection of economy at large. In many cases these businesses are family run with a long term vision and quite often a sense of responsibility for both the company and its employees. The legislator's intention to protect jobs is honorable. Protecting smaller sized businesses is an application of the politically as well as economically important principle of subsidiarity (Evans 2013).
- 2) A distinction between private persons and businesses can also be justified on the basis of the principle of subsidiarity that calls for a distinction of different levels; given their different social radius it can be justified to treat private persons and businesses as different entities from a legal perspective, even though the same moral principles apply to all spheres of human agency. This means that the same principles (such as common good orientation in the long term and the fostering of human and entrepreneurial freedom) apply to all economic stake holders, but because of the differences in kind different ways of implementing this orientation are ethically desirable. It does not violate a principle of equality if different entities are treated differently. According to our judgment it is the equality of the principles applied—such as common good and freedom—that determines respect for equality rather than the equality in treatment.

- 3) Thirdly, from our point of view a fiscal distinction between cash inheritances and business inheritances is well justified—based on normative programs with an emphasis on a primacy of labor over capital. There is an ethically relevant difference between “inheritance with inherent responsibility” such as a business with employees and “inheritance without inherent responsibility” such as cash to spend. There is also a difference between “labor-based wealth” and “capital-based wealth”, as spelled out in some documents of the Catholic Social Teaching tradition, particularly in the encyclical *Laborem Exercens* 12. This principle would also allow for a distinction between productive and unproductive assets; within this normative framework financial assets should be regarded as a second order capacity, as a tool to organize first order capacities, hence to be productive. Putting fiscal sanctions on unproductive assets can be justified in this framework.
- 4) The excessive exploitation of “freedoms of flexibility” is ethically questionable since a fiscal community cannot be constructed on a morally minimalistic framework. Hence, regulating those freedoms is an important and ethically well justified step. The Court’s call for a more precise description of the exception conditions is a good step towards a prudent fiscal system honoring differences.
- 5) The spread of horizontal equity lends weight to the notion of tax equality based on a performance capacity investment format, which must be taken into account particularly with regard to the taxation structures of “strong” businesses and should be more vigilantly pursued. Broadening the basis for taxation is in general desirable—this supporting argument against tax exemptions—but must be weighed against other goals, such as a clear understanding of the primacy of the smaller unit—the smaller business—in line with subsidiarity considerations. This also means that any ethical considerations of existing tax practices must bring to mind the Matthew Principle first stated by Robert Merton in 1968 in the context of a sociology of science. He made use of a passage from the gospel of Matthew: “For to all those who have, more will be given, and they will have an abundance; but from those who have nothing, even what they have will be taken away” (*Matthew* 25:29). This principle has become important in poverty research (Sedmak 2013, 170-174) pointing to the dynamics that subjects with higher agency levels will easily reach even higher levels whereas people with fewer assets face the risk of a downward spiral; for a fiscal context this would suggest that in drafting tax legislation, prime concern must be to minimize the opportunities to avoid or evade taxation for those with higher possibilities of earning more, since this will only go towards deepening the existing chasm in inequality. The risk of businesses with a larger workforce abusing or manipulating the system to their own advantage by splitting a company into

sub-units (holding companies) bears witness to the vulnerability of fiscal policy based on a Matthew Principle. The principle of investing effort and capacity should not be overlooked; hence, the decision reached to make tax evasion more difficult for larger sized companies is laudable.

- 6) Ethical considerations with regard to taxation underline the importance of thrift not only in administration of taxes, but also in simplifying legislation for the end-user. It does, thus, soon become apparent that small companies should be exempt from threshold tax-testing. At the same time, more effort must be made on the part of state legislation to simplify tax coding systems and exemption conditions. This is at odds with the call for prudential differentiation and, once again, a matter of weighing. In the current situation combining simplified tax security for smaller units is justified.
- 7) An important aspect of any tax discussion is the question of the relationship between the fiscal authorities and economic producers—Thomas Nagel and Liam Murphy have convincingly argued that the same state with the same laws can create property acquisition, thus creating a source of tax (cf. Maultzsch 2004). It is the same state asking for taxes that enables people to make money. It would be foolish and naive to believe that private property can exist “beyond” the state, and which the state then has to steal back as it were:

Private property is a legal convention, defined in part by the tax system; therefore the tax system cannot be evaluated by looking at its impact on private property, conceived as something that has independent existence and validity. Taxes must be evaluated as part of the overall system of property rights that they help to create (Murphy/Nagel 2002, 8; see Murphy 2005).

Seen thus, it can be forcefully argued for the principal moral justifiability of inheritance taxes (cf. Gaisbauer et al. 2013). This in turn suggests that the decision to make exemption more difficult to access is to be warmly welcomed. Extensive unregulated tax evasion protection is at the end of the day both ill-advised and foolhardy.

D. Conclusion

In conclusion, it is worth noting that any notion of inheritance tax must stem from the core principle of tax justice and a just taxation. Inheritance tax is by its very nature embedded in the whole issue of redistribution and common-good. The process of bequeathal and inheritance involves at least two parties (a donor and a recipient) whereby it is usually based on a “personal” relationship, and not on “merit” but “proximity.” This means that personal relationships may have to be balanced against formal relationships, between tax payer and state, but also against horizontal relationships between tax payers. Interestingly, the key element in all these relationships is trust. Trust is psychologically defined as the recognition of integrity, competence, benevolence, and reliability (Bierhoff and Rohmann 2010). Jerry Evensky has shown at the macro level that trust can be reconstructed as the foundation of economic activities in Adam Smith’s thought (Evensky 2011). The quasi-magical energy of markets that coordinate production and consumption is “unleashed by human freedom in almost magical ways . . . only where trust prevails” (Evensky 2011 at 250). Without trust, there can be no culture of private property, no incentive to cumulate or re-invest capital, no mechanism to obtain credits, in fact no monetary culture at all. It is our hope that the recent decision by the German constitutional court will enhance the trust in the fiscal system. This trust can be strengthened by (1) creating sustainable laws that will stand the test of constitutional screening, (2) offering plausible justification for fiscal policies including exemptions on clear normative principles, and (3) broadening the tax-paying basis without undercutting relevant human agency.

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