Ownership transfer – Critical Tax Issues

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INTRODUCTION

In tough economic times family owned businesses are particularly important. Family owned businesses make an essential contribution to the economy and their commitment to local communities and the responsibility they feel as owners bring long-term stability.

Europe's population is ageing and the need for improvement in the regulations for business transfers is increasing.

One third of European enterprises are facing a transfer within the next ten years. This was the conclusion in a Communication from the European Commission in 2006[1]. The same report estimates that there will be about 700 000 transfers per year. In order to increase Europe's competitiveness in line with the Lisbon Agenda the economic environment and support measures for business transfers need to be improved.

Already in December 1994 the Commission published a recommendation on the transfer of small and mediumsized enterprises[2] in which it invited Member States to:

- Encourage initiatives to increase awareness, information and training in order to ensure a timely preparation of business transfers.
- Provide a financial environment conducive to business transfers.
- Provide legal possibilities to restructure a business to prepare a transfer.
- Establish legal principles that ensure continuity of partnerships and sole proprietorships in the event of the death of one of the partners or the owner.
- Help the survival of businesses with appropriate inheritance and gift taxes.
- Facilitate the transfer of a business to third parties by appropriate tax rules.

In this report we compile some surveys covering transfer of ownership and taxation. We will try to describe what has happened in Europe since the report from the European Commission in 2006.

It is important to understand that better tax regulations not only make it financial viable to transfer a business but it will also release businesses from administrative burden and increase the possibilities to prepare businesses for successful transfers. Better tax regulations for transfer of businesses offer a great potential for growth and jobs.

TAXES ON ENTREPRENEURSHIP AND OWNERSHIP TRANSFERS IN EU

A case study from Deloitte covering 21 countries shows a clear trend over time for lower total taxes on entrepreneurship. Similar studies from PricewaterhouseCoopers with cases from up to 183 countries also show a global trend for lower total taxes on entrepreneurship.

The perhaps most visible tax on transfer of ownership in family businesses is the inheritance tax. We can see a trend for lower inheritance tax in Europe. By 2009 the tax was abolished in Austria, Cyprus, Estonia, Latvia, Slovakia, Spain and Sweden. Most EU member states have abolished the wealth tax and in EU it only exists in France. In Europe Norway and Switzerland outside EU still have a wealth tax.

A sale of a firm may uncover taxable reserves that have been accumulated over a long period and may lead to increased tax levels. According to the EU-survey Austria,

1 Communication from the commission to the council, the European parliament, the European economic and social committee and the committee of the regions, Implementing the Lisbon Community Programme for Growth and Jobs Transfer of Businesses – Continuity through a new beginning, Brussels, 14.03.2006 COM(2006) 117 final

2 94/1069/EC: Commission Recommendation of 7 December 1994 on the transfer of small and medium-sized enterprises (Text with EEA relevance) Official Journal L 385 , 31/12/1994 P. 0014 - 0017

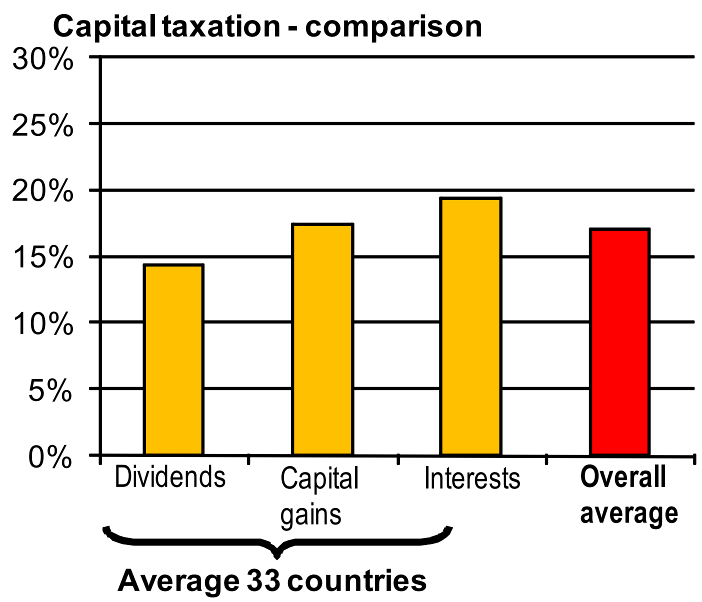
Belgium, Czech Republic, Denmark, France, Germany, Hungary, Ireland and Sweden have some kind och tax relief for retirement. Often these provisions are subject to special conditions such as minimum age of the seller, special tax treatment can only be used once.

Tax relief on sales where the proceeds of a sale are reinvested in another business only occurs in a few countries. Austria, Belgium, France, Germany, Hungary and Ireland have some kind of re-investment tax-relief.

CAPITAL TAXATION

Capital taxation is important for family owned businesses. Family businesses tend to be reluctant to accept external investors and avoid financial instruments that do not erode their control. Most family businesses have limited access to capital markets and therefore they try to build a capital base by retaining earnings. Debt and external equity comes as a last resort.

High capital taxation decrease the possibility to build a capital base. The figure below shows the result of a study of capital taxation in 34 countries made in 2008[3]. Taxes on incomes from dividends and capital gains are somewhat lower than taxes on interests.



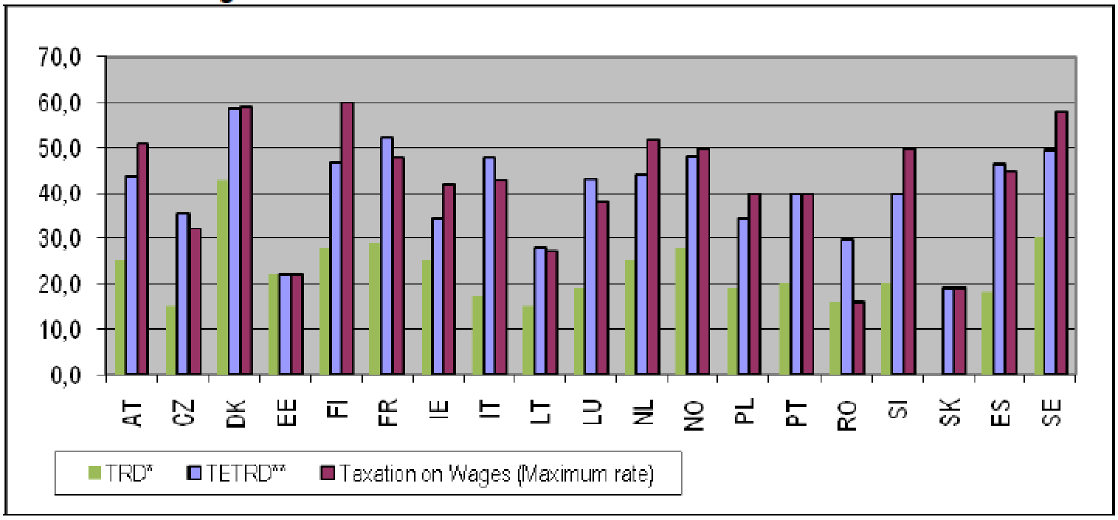
Tax systems affect the behaviour of the entrepreneur. A study made by Demolin, Brulard, Barthelemy on behalf of the European Commission DG Enterprise and Industry presents the difference in tax rates of wages and dividends in European countries[4].

3 Confederation of Swedish Enterprise, Taxation of capital income - Country Surveys, International Bureau of Fiscal Documentation, IBFD, 2009, Amsterdam The Netherlands

4 Jean ALBERT Study on Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity, February 15, 2008

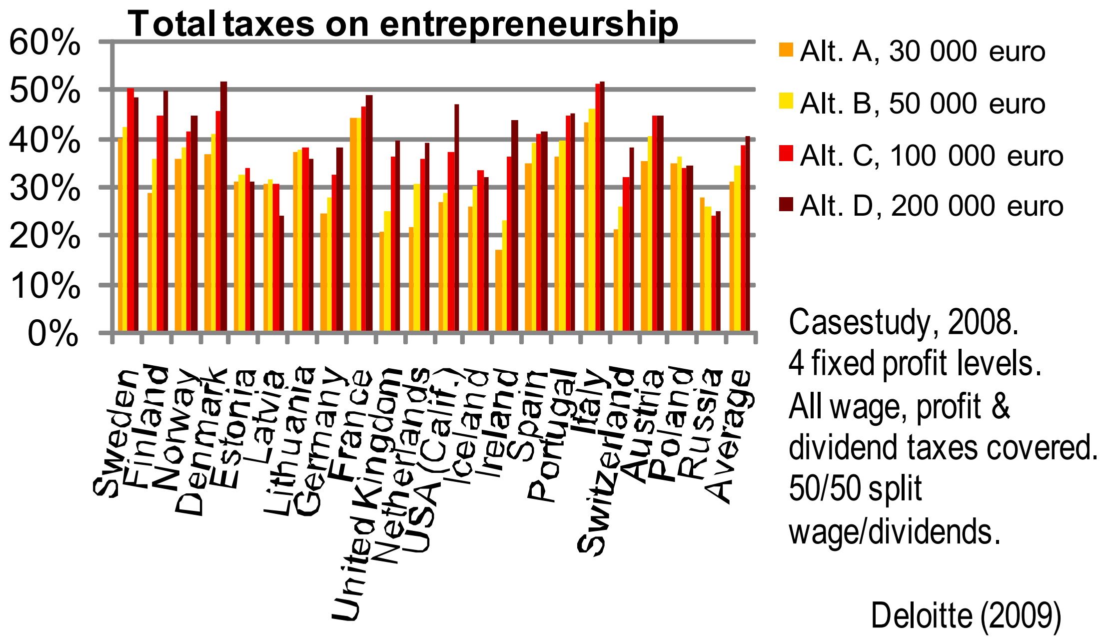
The study describes the situation regarding own equity of smaller companies in Europe, analyses current tax provisions of those countries and identifies how these systems tend to influence company owners' decisions to retain earnings. When private income is taxed at a lower rate than business income, it encourages distribution since the distributed money gives the business owner the opportunity to obtain private instead of business income. When the difference between the tax rate on business income and the tax rate on private income is significant, it creates strong incentives for business owners to choose private income. The graph below shows the tax rate on dividends and the total effective tax rate on dividends and the tax rate on wages.

Graph 17: Tax Rate on Dividends[88], total Effective Tax rate on Dividends and Tax rate on Wages[89]



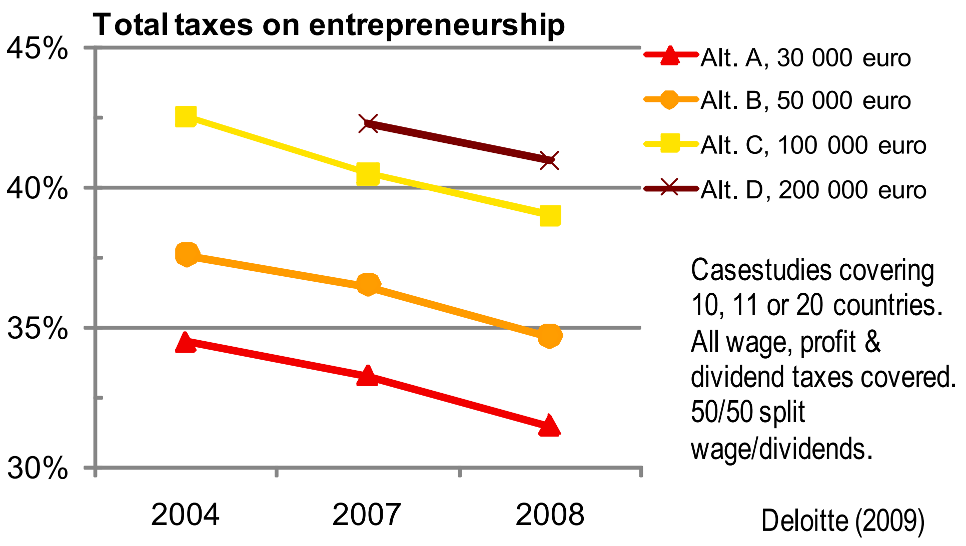
ON A PER COUNTRY BASIS IN PERCENTAGE
YEAR: 2006
*Tax Rate on Dividends
**Total effective Tax Rate on dividends
Sources: Country Reports and Ernst & Young World Corporate Tax Reports

The total taxes on entrepreneurship consist of many different taxes. One way to compare the taxes in different countries is to make calculation of the total taxes for a hypothetical business case. Deloitte made a case study on total taxes on entrepreneurship in ten European countries for the Confederation of Swedish Enterprise in 2009[5]. In this study Deloitte has made calculations for four fixed profit levels and all taxes on wages, profits and dividends are covered. The profit is split in 50 percent wage and 50 percent dividend (before corporate taxes). The result of this study is shown below.

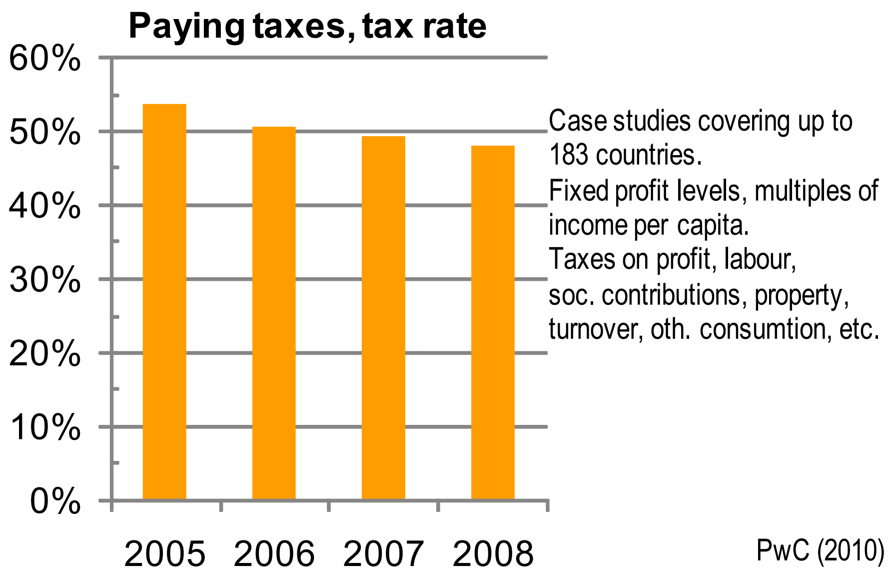


Similar studies have been conducted by Deloitte for 2004 and 2007. This makes it possible to calculate a trend in the total tax rates. There is a clear trend for lower total tax rates on average in these studies, see graph "Total taxes on entrepreneurship".

5 Deloitte/Confederation of Swedish Enterprise, Stockholm 2009



A more extensive report on total taxes is Paying Taxes 2010 by the World Bank and PricewaterhouseCoopers. This report includes case studies covering up to 183 countries and the average trend from 2005 to 2008 is the same as in the Deloitte study.



INHERITANCE TAX

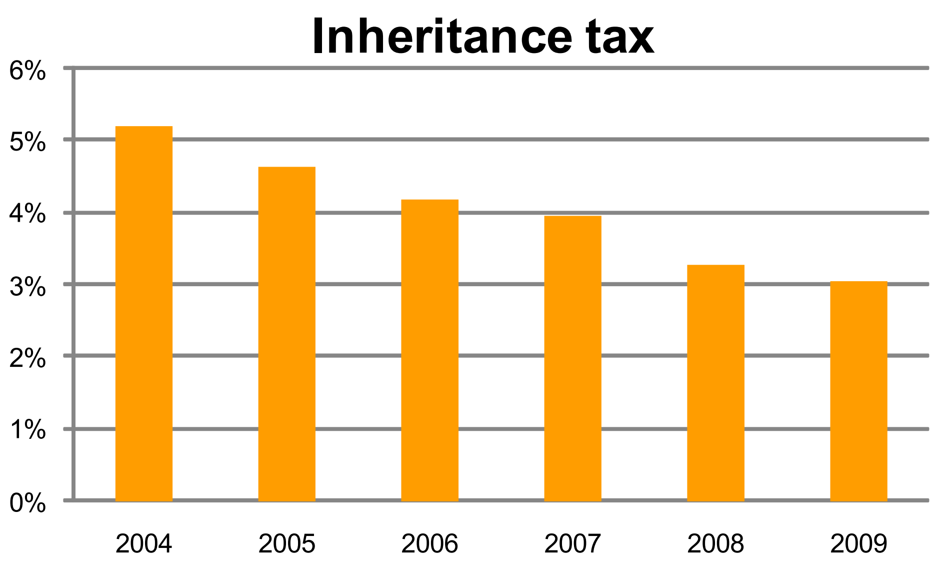
The perhaps most visible tax on transfer of ownership in family businesses is the inheritance tax.

AGN International, a worldwide association of separate and independent accounting and consulting firms, make annual surveys of the inheritance tax based on case studies for a sample of 19-29 European countries[6].

The inheritance tax-case in the AGN European Region –study A married individual who dies on January 1, 2009, leaving a spouse and two children. The assets owned at death are: a house worth €600.000,00, cash of €1.000.000,00, quoted company shares valued at €300.000,00 and unquoted company shares valued at €700.000,00 (total asset value €2.600.000,00). The deceased is assumed to have left no will (which is a common observation in all countries surveyed even though an up-to-date will should be an essential element of every family's financial planning).

The cases have fixed assumptions regarding family situation, assets, wealth composition etc. The results in the 2009 study show some substantial differences. We can see a clear trend for lower inheritance tax in Europe. However the results are sensitive to assumptions of family situation, countries involved etc. By 2009 the tax was abolished in Austria, Cyprus, Estonia, Latvia, Slovakia, Spain and Sweden.

Some countries have tax reliefs in the inheritance tax for businesses. In the United Kingdom the transfer of business assets can be completely exempt from taxes. Other countries provide tax free amounts or other tax reliefs[7].



6 2009 Inheritance Tax Survey, The AGN European region , London, UK.

7 Communication from the commission to the council, the European parliament, the european economic and social committee and the committee of the regions, Implementing the Lisbon Community Programme for Growth and Jobs Transfer of Businesses – Continuity through a new beginning, Brussels, 14.03.2006 COM(2006) 117 final

WEALTH TAX

Wealth tax on assets has in previous time been a serious problem for family businesses in many European countries.

Most EU member states have abolished the wealth tax and in EU it only exists in France. In Europe Norway and Switzerland outside EU still have a wealth tax.

Spain	Abolished 2008
Sweden	Abolished 2007
Finland	Abolished 2006
Luxembourg	Abolished 2006
Iceland	Abolished 2005
Netherlands	Abolished 2000
Denmark	Abolished 1997
Germany	Abolished 1997
Austria	Abolished 1994
UK, Ireland, Italy, Belgium, Portugal, Greece, Estonia, Latvia, Lithuania, Russia, Poland, Ch. Rep., Slovakia, Slovenia, Hungary, Cyprus, Malta, Romania, Bulgaria, Japan, USA, Canada, Australia, New Zeeland	No net wealth tax in any of these countries
France	0,55-1,8% above 790 000 €
Norway	0,70-1,1% above 40 000 €
Switzerland	0,05-1,5% above 50 000 €

GIFT TAX, RE-INVESTMENT TAX RELIEF AND RETIREMENT TAX RELIEF

In 1994 the EU Commission recommended it´s member states to help the survival of businesses with appropriate inheritance and gift taxes on the transfer of small and mediumsized enterprises.

In a number of countries gift taxes have been reformed to facilitate transfers within the family. As regards taxes that affect the transfer to third parties, i.e. personal income tax, corporation tax and capital gains tax, only few countries appear to have followed the 1994 recommendation.

Transfer of a family firm triggers a series of financial constraints which may endanger the viability of the business. Apart from the inheritance tax, payment of the gift tax represents the biggest challenge to transfer of businesses within the family. Tax systems are typically set up to counteract wealth accumulation and may as a result put financial pressure on the family company, which can threaten the capital base. Transfer process may require funds to buy the shares of heirs not willing to be involved in the business. However the situation varies between EU member states.

A transfer of ownership of a firm generally requires more financial funds than a start-up since not only the material and financial assets have to be paid for but also the relations with clients, suppliers, trade reputation, expectations of future returns etc.

Re-investment tax relief

A sale of a firm may uncover taxable reserves. Only a few countries provide for special income tax reliefs in cases where the proceeds of a sale are reinvested in another business. The communication from the EU Commission in 2006 reports that only Austria, Belgium, France, Germany, Hungary and Ireland have some kind of re-investment tax-relief.[8]

Retirement tax relief

As mentioned above a sale of a firm may uncover taxable reserves that have been accumulated over a long period. In most countries capital gains or income taxes affect this profit during a shorter period, thus increasing the taxes.

According to the EU-survey Austria, Belgium, Czech Republic, Denmark, France, Germany, Hungary, Ireland and Sweden have some kind of tax relief for retirement. Often these provisions are subject to special conditions such as minimum age of the seller, special tax treatment can only be used once.

8 Communication from the commission to the council, the European parliament, the European economic and social committee and the committee of the regions, Implementing the Lisbon Community Programme for Growth and Jobs Transfer of Businesses – Continuity through a new beginning, Brussels, 14.03.2006 COM(2006) 117 final

TAX-INITIATIVES TO SUPPORT TRANSFER OF OWNERSHIP IN PRIVATE BUSINESSES

	No inheritance tax	No gift tax	No wealth tax	Re-investment tax relief	Retirement tax relief
Austria	☑	☑	☑	☑	☑
Belgium	☒	☒	☑	☑	☑
Bulgaria	☒	☒	☑	–	–
Cyprus	☑	☑	☑	☒	☒
Czech Republic	☒	☒	☑	☑	☑
Denmark	☒	☒	☑	☑	☑
Estonia	☑	☑	☑	☒	☒
Finland	☒	☒	☑	☒	☒
France	☒	☒	☒	☑	☑
Germany	☒	☒	☑	☑	☑
Greece	☒	☒	☑	–	–
Hungary	☒	☒	☑	☑	☑
Ireland	☒	☒	☑	☑	☑
Italy	☒	☒	☑	☒	☒
Latvia	☑	☑	☑	–	–
Lithuania	☒	☒	☑	☒	☒
Luxembourg	☒	☒	☑	☒	☒
Malta	☒	☑	☑	☒	☒
Netherlands	☒	☒	☑	☒	☒
Poland	☒	☒	☑	☒	☒
Portugal	☒	☒	☑	☒	☒
Romania	☒	☑	☑	–	–
Slovakia	☑	☑	☑	☒	☒
Slovenia	☒	☒	☑	☒	☒
Spain	☒	☒	☑	–	–
Sweden	☑	☑	☑	☒	☑
United Kingdom	☒	☒	☑	☒	☒

References: Brussels, 14.03.2006 COM(2006) 117 final, communication from the commission to the council, the European parliament, the European economic and social committee and the committee of the regions, Implementing the Lisbon Community Program for Growth and Jobs

2009 Inheritance Tax Survey, The AGN European region , London, UK.

Taxation of capital income - Country Surveys, International Bureau of Fiscal Documentation, IBFD, 2009, Amsterdam

The Netherlands.