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It's the inheritance tax, stupid

Enduring family businesses: Why are they more commonplace in Germany than in the USA?

President Donald Trump is planning a sea change in tax policy. In November, he presented "H.R. 1. The Tax Cuts and Jobs Act" – draft legislation designed to enact major tax reductions. The plans include the abolition of inheritance tax, a tax that Trump has described as "horrible" and "a disaster". If the changes are passed, American family businesses will, for the first time, be placed in a better position than their German counterparts when passing on assets to the next generation. For now, the Senate and House of Representatives are still debating the reform. The House Bill plans to repeal the inheritance tax by 2024 and to immediately increase the deduction to US$ 11 million. The Senate version does not fully repeal the tax, but increases the deduction threshold.

Should the House of Representatives prevail, the result would be a break with an American tax policy that has been central to some of the major differences in the corporate landscape between Germany and the United States. In Germany, large family businesses are the backbone of the economy. In the US, by contrast, they have a much smaller presence.

So why are family businesses such a feature of the German economy, and why do German family businesses tend to survive longer than their American counterparts? The preliminary findings of a largescale research project on this question show that alongside differences in politics, culture and capital market structures, the way in which the tax system treats inheritance is key. The inheritance of business assets has long been subject to high rates of taxation in the US. An individualistic, meritocratic philosophy has dominated, which regards inherited assets as undeserved. "No man should receive a dollar unless that dollar has been fairly earned," said President Theodor Roosevelt in 1910. By this logic, ownership ends with the individual's death, whereupon the state is entitled to decide what happens to the property of the deceased.

The Americans wanted to explicitly distance themselves from the British hereditary monarchy and the dynastic wealth accumulation of the aristocracy. The United States was to become the country where those who worked hard would have unlimited opportunities, without having to rely on the means of their forefathers. This idea has engendered a long tradition of high inheritance taxes.

In 1924, the top rate of estate tax in the US was 40 percent, and it increased to as high as 77 percent between 1941 and the tax overhaul of 1976. Many family businesses lacked the liquidity to meet their tax liability and were forced to sell their companies.

The political direction did not change until the Reagan era, when spouses were exempted from the estate. The top rate for all others was cut to 55 percent. George W. Bush passed an act reducing the top rate even further and planned to abolish the tax altogether by 2010. However, this plan was overturned by Barack Obama. Since 2013, the inheritance tax has stood at 40 percent.

As a result of this tax regime, entrepreneurial families in the US are today often connected by no more than name to the companies they founded. The freedom to dispose of estate without restriction by compulsory portions for the next of kin, combined with the high tax burden, has probably contributed to the loss of families' ownership over businesses. Besides, large philanthropic donations were traditionally preferred to business continuity; dying rich was considered a "disgrace".

This pattern still applies to large parts of the US economy: George Soros, Warren Buffet and the Microsoft founder Bill Gates are famous examples of multientrepreneurs who have already transferred large fortunes to foundations, or plan to do so in future. Many of these foundations play an important social role, such as supporting schools or universities. However, very few of them have solely philanthropic motives; they also serve the desire to place corporate assets beyond the reaches of the estate tax.

In Germany, by contrast, lawmakers have aimed for continuity of ownership, keeping companies within the family from one generation to the next. The first inheritance tax was introduced in 1906, ten years earlier than in the United States. Both countries chose fundamentally different structures. In Germany, spouses and children were initially exempted. Later, except in the early Weimar Republic, they paid no more than the modest top rate of 7 percent introduced in 1925.

After the Second World War, the tax framework remained an important element in the success of German family businesses. Initially set at 7 percent, the top rate of inheritance tax rose to 15 percent between 1959 and 1973. Un er Chancellor Willy Brandt it was increased to 35 percent, but only applied to assets exceeding DM 100 million and was mitigated by high exemptions. These tax policies have served to keep long-standing companies within the family. Twenty-six of the 500 largest family businesses in Germany were founded before the year 1800, and the average German family business in this sample has been in operation for 101.8 years, as a survey by the Centre for European Economic Research (ZEW) in Mannheim has revealed. Germany's family business-dominated corporate landscape is envied internationally for more than just the anchor of stability it provided in the 2008 global financial crisis. Between 2006 and 2014, the

500 largest family businesses increased the number of employees in Germany by 19 percent. Non-family-owned DAX companies managed a rise of just 2 percent over the same period.

The latest legislative moves in Germany and the US have been in opposite directions. Here in Germany, protecting the business assets of large family businesses from tax was made more difficult in 2016. Meanwhile, Trump plans the abolishment of taxes for families looking to business pass assets on to the next generation – cuts that, incidentally, many European countries have already implemented. Of course, Trump's draft tax plans are not about to change the American corporate landscape overnight. It is worth noting too that his draft legislation makes no distinction between business and purely private assets, which is likely to trigger debate on whether the plans are socially just. We will see in due course whether Trump's position can win a majority.

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